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EXAMINING THE IMPACT OF THE SARBANES-OXLEY ACT AND DEVELOPMENTS CONCERNING INTERNATIONAL CONVERGENCE

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

ON

REGULATIONS IN THE UNITED KINGDOM AND HONG KONG, STRENGTHENING CORPORATE GOVERNANCE AND INTERNAL CONTROLS, CONCERNS OF SMALL COMPANIES, AND THE CHANGED BEHAVIOR OF AUDIT COMMITTEES, MANAGEMENT, AND AUDITORS

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C O N T E N T S

TUESDAY, SEPTMEBER 9, 2004

EXAMINING THE IMPACT OF THE SARBANES–OXLEY ACT AND DEVELOPMENTS CONCERNING INTERNATIONAL CONVERGENCE

THURSDAY, SEPTEMBER 9, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:36 p.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order. As I have told several of you, I am sorry but we have had two back-to-back votes, and the floor prevails over the Committees, as everybody knows.

One year ago upon the anniversary of the Sarbanes-Oxley Act, this Committee held a series of hearings devoted to examining the implementation of the Sarbanes-Oxley Act. At that time, we reviewed newly promulgated regulations, discussed upcoming rulemakings, and considered reforms already underway in corporate boardrooms and accounting firms. To date, our review has primarily focused on the domestic impact of the legislation. This afternoon, the Committee broadens its consideration of the Act by examining it in the context of convergence of U.S. and institutional governance, accounting, and audit principles.

Nearly simultaneous with the enactment of Sarbanes-Oxley in 2002, the Financial Accounting Standards Board and the International Accounting Standards Board were formalizing an agreement to undertake a convergence project. FASB and the IASB agreed to work cooperatively in an attempt to develop a single set of high-quality accounting standards that could be used internationally. This project involves eliminating differences between current standards and undertaking future projects together in order to ensure that the new standards are similar. As global capital markets evolve, the need for convergence on accounting principles becomes more apparent.

First, a uniform set of international standards reduces the compliance costs for corporations by minimizing conflicting regulations. Second, uniform standards should facilitate cross-border transactions by eliminating inefficiencies and promoting comparability of financial information. The FASB and IASB convergence project is one example of efforts underway to avoid regulatory conflicts and

promote international business. For the past 21 years, the International Organization of Securities Commissions has facilitated a multilateral dialogue aimed at enhancing cooperation among international securities regulators and improving the regulation of securities markets. As a result, the benefits of convergence will become evident not only with respect to accounting principles, but also regarding auditing standards and governance principles.

And although differences will inevitably arise during the convergence process as local jurisdictions promote particular interests, it is important that the international dialogue remain focused on long-term goals and that regulatory bodies work toward consensus. Further, I strongly believe that we should seek to insulate the convergence process from regional political calculations. To the extent that political pressures compromise the process, there is a risk that we fall behind global developments and our standards are seen as inadequate. If this occurs, U.S. companies may suffer the consequences of less liquidity and restricted access to capital.

This afternoon, this Committee will examine the Sarbanes-Oxley Act within this context of convergence. The legislation has had a significant impact on international companies listed in the U.S. markets and their auditors. It is important to understand how international companies and the agencies that regulate them are working to harmonize the mandates of the Act with their respective national laws and business practices. As the convergence process unfolds, we should be mindful of the impact of our laws on international markets and how regulators might address particular concerns during the implementation process.

It has only been 2 years since enactment of Sarbanes-Oxley, and the SEC and Public Company Accounting Oversight Board continue to implement the Act and establish compliance programs. As with any landmark legislation, companies will experience a certain amount of uncertainty and compliance costs as they implement the law and modify their business practices and operations. Although I acknowledge increased compliance costs associated with implementing Sarbanes-Oxley, I also recognize that certain costs were necessary to restore investor confidence and address the surprising erosion of business principles. During the coming months as the implementation process continues, we should be sensitive to the impact and costs and benefits of new rules and regulations.

We have a very distinguished panel with us today to discuss these issues. Sir David Tweedie is the Chairman of the International Accounting Standards Board. Mr. Andrew Sheng is Chairman of the Securities and Futures Commission of Hong Kong and Chairman of the Technical Committee of the International Organization of Securities Commissions. Finally, Mr. Paul Boyle is the Chief Executive of the Financial Reporting Council of the United Kingdom. I thank each of you for traveling here to be with us today. We look forward to hearing your perspectives.

We will also hear from a second panel comprised of executive officers from various domestic and international corporations. The witnesses on the second panel will be: Mr. Greg Bentley, President and Chief Executive Officer of Bentley Systems; Mr. Douglas Flint, Group Finance Director of HSBC Holdings and Member of the U.K. Accounting Standards Board; Mr. Arnie Hanish, Chief Accounting

Officer of Eli Lilly & Company; Mr. Len Moodispaw, President and Chief Executive Officer of the Essex Corporation; and Mr. James Turley, Chairman and Chief Executive Officer of Ernst and Young. We look forward on the second panel to their insights concerning the Sarbanes-Oxley Act and how its implementation has impacted their businesses.

Senator Enzi, do you have an opening statement?

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I thank you very much for holding this important hearing and putting together these distinguished panels. When we passed the Sarbanes-Oxley Act a little more than 2 years ago, we faced a crisis of investor confidence in our Nation's accounting and corporate governance standards. The law was intended to restore the financial accounting foundation of our public markets and bring attention to the vital importance of corporate ethics and corporate governance. There is little doubt that the law has had the intended effect on the Nation's markets. In fact, it has even had the intended effect on the Nation's schools and colleges, as well as the businesses. I find a lot more ethics courses everywhere.

At the time we passed the law, we recognized certain sections of the law may affect companies and accounting firms located outside the United States. However, we believed that the extent would not impede or interfere with the operation of foreign securities markets and/or accounting standards. Since then, we have received many anecdotal stories about positive and sometimes negative effects. It is my understanding that the Securities and Exchange Commission and the Public Company Accounting Oversight Board have undertaken extensive outreach efforts to ensure foreign entities' concerns are taken into consideration during the implementation of the Sarbanes-Oxley Act. I applaud their efforts and their staff's efforts.

Today's hearing will help us to understand the extent of the Sarbanes-Oxley Act on foreign accounting firms and corporations. In addition, this hearing will help us to understand the nature and progress made on the convergence of U.S. and international accounting standards. Overall, the convergence of accounting standards is a lofty goal. For many, many years, the United States has been criticized that its accounting and corporate standards were placing barriers on foreign corporations and investments. Many believed that the convergence of accounting standards will help to open doors for foreign countries to list in the United States and for U.S. investors to invest in foreign markets.

Generally, I have been supportive of the convergence efforts as it will open new markets and create new efficiencies for corporations. Currently, accounting firms and U.S. companies have been focusing all of their efforts on the implementation of the Sarbanes-Oxley Act provisions. While we have just passed the second anniversary of the law, there is a still a tremendous amount of compliance work to be done, such as the oversight of the internal controls, as required by Section 404.

On the international front, I understand that the International Accounting Standards Board is working to finalize many accounting standards in order to meet the January 1, 2005, deadline estab-

lished by the European Union for the recognition of international accounting standards. This project, together with the convergence efforts with the U.S. accounting standards, is quite an undertaking. I would like to applaud the IASB's effort to address accounting concerns of small and medium-sized enterprises. The IASB released a request for comments in July of this year to receive input from small entities on implementation of accounting standards.

As you know, I requested the Financial Accounting Standards Board to set up a small business advisory committee in which FASB held the committee's first meeting in May, and I really appreciate that response. As we have found out from Federal agencies' rulemaking, it is always better to receive the input of small business early in the process. Once a rule has been finalized, then it is extremely difficult to take the small business issues into consideration, which could have easily been worked out in the final rule if the small business had been consulted first. So, I really appreciate that effort on behalf of FASB, and I thank you, Mr. Chairman, for holding this hearing.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman, and I welcome the panel that is before us and the one that is to follow. And it is always a pleasure to have Sir David Tweedie here before us.

The European Commission is working to adopt international accounting standards beginning in 2005, as I understand it, so a focus on convergence of U.S. and non-U.S. accounting and regulatory standards is very timely.

The *Financial Times* reported just this Tuesday that a study of 2,500 international companies showed, "that U.S. companies have risen to the top of a global comparison of corporate governance standards. The Sarbanes-Oxley Act and other reforms implemented following recent scandals have succeeded in improving the relative performance of large U.S. companies by more than 10 percent."

The *Financial Times* also reported findings confirming "a link between share price performance and adherence to corporate governance best practice."

Convergence of standards can foster international investment while maintaining or even enhancing investor protection, but only if convergence embodies the highest standards, and those standards are consistently applied by all countries involved. U.S. investor protection, auditing, accounting, and corporate governance rules should continue to set or reflect the highest standards.

For this to be the case, it is my strongly held view that independent regulators and standard-setters must remain free of political interference.

We have been reminded during the past year that non-U.S. companies are not immune from Enron-like breakdowns. Large public companies in Italy [Parmalat]—the United Kingdom and the Netherlands [Shell]—and Canada [Nortel and Hollinger]—most of which are listed in the United States, are now faced with evidence of poor internal controls, weak corporate governance, and substantial audit failures.

Mr. Chairman, I look forward also to the testimony of our witnesses examining the impact of the Sarbanes-Oxley Act. The Act is now beginning to take full effect. The SEC and the Public Company Accounting Oversight Board, the PCAOB, have properly recognized that the Act creates a framework within which they are granted significant discretions to make adjustments consistent with the spirit of the Act. The SEC, in one example, has proposed postponing accelerated reporting deadlines for most public companies, because this is the first year in which the crucial internal control certification rules of the Act apply. Strong internal controls are not only required for accurate financial statements but also to prevent misuse or theft of corporate funds. Strong controls produce the verified information without which independent board members, and the other gatekeepers on whom investor protection depends, cannot do their jobs. Properly implemented, those controls support the ethical "tone at the top" for which SEC Chairman Donaldson and others have called.

Mr. Chairman, before I close, I want to commend again the leadership and staff of the SEC and the PCAOB. The SEC has issued an unprecedented number of rules in a very short time. The PCAOB has established itself as a serious and professional organization in less than 24 months. *The Washington Post* reported on August 27 that, "Accounting scholars and industry experts who read the Board's recently released partial inspection reports of the Big Four accounting firms said they were surprised at their thoroughness, especially because Board inspectors were operating at barebones staffing levels at the time. 'This is a clear signal from the Accounting Board that it is not business as usual,' said Charles Mulford, an accounting professor at the Georgia Institute of Technology."

I also believe that the U.S. Financial Accounting Standards Board, the FASB, the PCAOB, and the SEC are conducting fair, open, and transparent proceedings at which all parties have the opportunity to be heard. I am sure those organizations will consider carefully the views that will be expressed by all of our witnesses here this afternoon. I look forward to hearing their testimony.

Thank you, Mr. Chairman.

Chairman SHELBY. Before we get into our witnesses, I want to note we are fortunate to have Chairman Jeffrey Lucy of the Australian Securities and Investment Commission and some of his colleagues visiting us today. Mr. Chairman, it is a pleasure to see you again, and I hope you will add something to this and maybe take something from this hearing. Thank you very much.

Mr. Tweedie, we will start with you. All of your written testimony will be made part of the hearing today in its entirety. You proceed as you wish.

STATEMENT OF SIR DAVID TWEEDIE, CHAIRMAN INTERNATIONAL ACCOUNTING STANDARDS BOARD

Sir DAVID TWEEDIE. Thank you, Mr. Chairman, Members of the Committee. I have been asked to appear here today in my role as Chairman of the International Accounting Standards Board. This is my second appearance now before the Banking Committee, the previous occasion being in February 2002, and I wanted to use this

opportunity to give you an update on the work of the IASB and, particularly, its joint efforts with FASB to bring about international convergence of standards.

When I last appeared before the Committee, you were faced with the response to Enron and the other corporate scandals. Let me say that I believe that the work that this Committee spearheaded and the many others involved with the creation of the Sarbanes-Oxley Act has served as a catalyst for positive change in accounting and financial reporting throughout the world. Many other countries have accelerated similar reforms and in Europe and elsewhere, many of the principles of the Sarbanes-Oxley Act have been adopted. At the same time, differences will undoubtedly still arise, and in particular, between U.S. and other national and international audit standards. I would suggest that the model for convergence being used by the IASB and the FASB might provide a useful framework for the convergence of audit standards worldwide. I will leave it to Mr. Boyle to discuss the specific reforms in the United Kingdom.

The effective functioning of capital markets is essential to our economic well-being. In my view, a sound financial reporting infrastructure must be built on four pillars: First, accounting standards that are consistent, comprehensive, and based on clear principles to enable financial reports to reflect underlying economic reality; second, effective corporate governance practices, including a requirement for strong internal controls, that implement the accounting standards; third, auditing practices that give confidence to the outside world that an entity is faithfully reflecting its economic performance and financial position; and, fourth, an enforcement or oversight mechanism that ensures that the principles as laid out by the accounting and auditing standards are followed. The Sarbanes-Oxley Act refocused attention on these pillars and provided many useful approaches that will be used throughout the world to improve the financial reporting environment.

As to the first of the four pillars I mentioned—accounting standards—much has been accomplished both internationally and in the United States during the last 2 years. Today, I would like to focus on two specific developments in the standard-setting world that I believe are of immense significance. First, the growing acceptance of international standards throughout the world. Second, the effort to bring about convergence between international standards and U.S. GAAP. I will come back to convergence shortly.

As the world capital markets integrate, the logic of a single set of accounting standards is evident. A single set of standards enhances comparability of financial information and makes the allocation of capital across borders more efficient. The development and acceptance of international standards should also reduce compliance costs for corporations and improve consistency in audit quality.

During the past 2 years, many countries have agreed to adopt international standards for publicly traded companies by either January 1 next year or January 2007. As widely reported in the press, the European Union has adopted a regulation that will require publicly traded companies to apply international standards beginning next year. It is not often known that while we have 25

member states in the European Union, we actually have 26 different ways of accounting. Only Great Britain and Ireland account the same way, which leaves 24, and, in addition, countries can allow in certain areas the use of U.S. GAAP or international standards. You cannot run a single market with 26 different ways of accounting. It is expected that in addition to the 7,000 listed companies in Europe, hundreds of thousands of unlisted companies will now choose to adopt international standards, depending on national law.

The momentum in favor of adopting standards is not limited to Europe. Recently, Australia, New Zealand, and Russia followed the European Union's lead in requiring international standards. A Deloitte and Touche survey now estimates that 92 countries will either require or permit the use of international standards for public accounts of listed companies by January next year. Additionally, many other countries, such as China and many of the ASEAN countries, have a policy of seeking convergence of national standards with international standards. We have recently offered Japan a similar convergence deal as the agreement we had with the United States, and the idea is that they would converge with both of us.

I want to touch on in some detail the convergence with the United States, and I appreciate that this may be remote for some of you, but coming from Scotland, I am used to that. One of my partners in KPMG came with me to the islands off the west coast of Scotland for an investigation, and being a London partner he had to keep up-to-date, so he went into the news agent and asked for a copy of the *Financial Times* and was a bit taken aback when the old lady said to him, "Will you be wanting today's or yesterday's?" But coming from London, of course, he had to have to have today's. "Well," she said, "you will have to come back tomorrow."

[Laughter.]

As I mentioned, the IASB and the FASB have made much progress in the convergence of international standards and U.S. GAAP during the past 2 years. We have received strong support from the U.S. Securities and Exchange Commission and the European Union, as well as from the corporate community throughout the world. Indeed, the European Roundtable said this was the most important project we could undertake and it is at the top of their priority list.

Our convergence drive began formally after our first joint meeting with the FASB and the IASB. At that meeting, in a decision later formalized in what we call the "Norwalk Agreement," we agreed to try to eliminate the differences between our existing standards in the near-term and work together on long-term projects to ensure that the principles behind, if not the wording of, the new standards will be the same.

Our philosophy is clear. Our goal is to develop between us a single set of high-quality standards that can be used internationally. No matter whether a transaction takes place here in Washington or in Wellington, New Zealand, or in Warsaw, Poland, we will have the same answer. That is not the case at present. This is not convergence for convergence's sake, but an attempt to improve the consistency and quality of financial reporting worldwide. I have al-

ready mentioned the potential benefits for global capital markets. More narrowly in the United States, as my colleague Bob Herz, Chairman of the FASB, often says, this is an opportunity to "kill three birds with one stone," first, by improving U.S. reporting; second, by simplifying U.S. standards and standard-setting; and, third, by offering U.S. market participants the benefits of international convergence, both for listing on the New York exchanges or for American investors to invest overseas.

I want to give you examples of the depth of cooperation which I think people do not quite realize exactly what we are doing. We have a full-time IASB board member who maintains an office at the FASB and participates in their deliberations. We meet jointly twice a year. We have video links between each other's meetings, so board and staff can participate in and observe each other's discussions. We have joint staffing teams to work on several projects.

Although there have been doubters on both sides of the Atlantic, convergence has been and will continue to be a two-way process in an effort to build a set of standards which we would call "the best of breed." We have shown our commitment to change toward the better answer and to accept the input of another standard-setter if we believe that he has a better answer than either of us. The IASB has brought many international standards in line with U.S. GAAP during our improvements project getting ready for 2005, and our standards on business combinations and discontinued operations are the American standards.

The FASB has already published four exposure drafts related to our short-term project and hopes to finalize these in the near future. And as the Committee knows, the FASB has also proposed bringing the U.S. requirements on accounting for stock options in line with our standard, which requires expensing.

I realize that in certain circles this standard is as much appreciated as the arrival of a virus in a maternity ward. But it really is a very important standard internationally, and we feel that this is an essential one, which is why FASB has taken it on.

The other major projects on which we are working include revenue recognition, performance reporting, and other business combination issues. We are aligning our work programs to ensure that we do not create new differences.

Without putting a specific date on it, we hope that the major differences between our two standards will be removed in the next few years. Elimination will increase pressure on the SEC to remove the reconciliation requirement. We are trying to ensure this does not have to be a political decision. We just want to remove the differences so that reconciliation will not be required at all.

The impediments to success. We face some serious challenges. Some of them are intellectual. The standard-setting bodies are facing difficult conceptual issues. On our agenda, as in insurance accounting, we do not believe insurance accounting is satisfactory anywhere in the world. We are looking at off-balance sheet issues such as leasing and pensions, which have even here in America billions of dollars off-balance sheet. We also believe we need a new financial instruments standard.

Reaching common agreement on such topics will not be easy because we are all starting from different points with different na-

tional practices and cultural backgrounds. What we have to do is ensure that we engage with our constituents, evaluate the many options, and choose what is generally accepted as the best answer.

We have also to overcome resistance to change. We recognize in the aftermath of Enron and the adoption of new accounting standards and the issues of Sarbanes-Oxley that corporate preparers and auditors have come through a turbulent period. It is our responsibility to time the new requirements appropriately. At the same time, we have to remember the general public good and the potential long-term benefits that will arise from promoting common financial reporting rules.

The other area we are going to have difficulties is the question of rules versus principles. This is not going to be an easy issue. I do not know if you have noticed, but the Lord's Prayer has 57 words. The Ten Commandments has 297. The United States Declaration of Independence—a big mistake that was—300 words.

[Laughter.]

And the European Commission's Directive on the import of caramel products, 26,911 words.

The SEC and the FASB have done some excellent research of the possibilities and consequences of adopting a more principle-based approach. Internationally, there is a clear desire to maintain a more principle-based approach to accounting. In the United States, I sense a similar desire to reduce the complexity and sheer volume of accounting literature. This will not be easy, but I believe the benefits of such an approach will help reduce the complexity but, more importantly, to improve accounting in general. It is not black and white, and there will always be a need for some explanatory guidance. But in promoting international convergence, we are determined to focus on crafting principles that are sufficiently clear to make a lot of detailed rules unnecessary.

Finally, if convergence is to succeed, we have to resist attempts to reject standards through political processes rather than the standard-setting process when local or regional interests perceive adverse consequences in particular standards. I am by no means dismissing the right of national authorities and legislatures to examine the standards and the need for effective oversight of the standard-setting boards. What I am saying is that if political pressures in a national or regional context are able to overrule standards that have been developed in a deliberate and open manner, then we may end up having a system of "beggar thy neighbor" standards, which will not produce the consistency and quality of standards the world's markets demand and will not lead to the appropriate allocation of resources in the capital markets.

The standard-setting process, both in the United States and ours, which is based on that in the United States, has carefully constructed mechanisms aimed at assuring both independence of the technical board and sufficient due process including public consultation and transparent decisionmaking. At the IASB, we have a body of trustees, chaired by Paul Volcker, which has the responsibility for oversight and ensuring that the IASB works in the public interest. Our trustees' role is to protect the independence of the decisionmaking process of the IASB, on the basis that neutral and fair accounting standards, set independently, by people seeking

what they really genuinely believe is the best answer, are in the best interest of investors.

As Mr. Volcker recently testified to another Senate Committee, he said, "The net result of politicized national decisions would be to weaken, perhaps irreparably, one of the foundation stones of effective accounting practices in a rapidly globalizing world economy." I believe that allowing such a situation to occur would be to waste a real, and probably a once-in-a-lifetime, opportunity to develop truly global high-quality accounting standards.

Gentlemen, the world is actually looking at the U.S. Senate at this moment to see if it can deliver on this promise.

May I thank you, sir, for your continued support for independent standard-setting and international convergence, and in due course, I would very much welcome your questions.

Thank you.

Chairman SHELBY. Mr. Sheng.

STATEMENT OF ANDREW SHENG CHAIRMAN, SECURITIES AND FUTURES COMMISSION OF HONG KONG

Mr. SHENG. Thank you very much. Good afternoon, Chairman Shelby, and distinguished Members of the Senate Committee.

Chairman SHELBY. Bring your mike close to you just a little.

Mr. SHENG. Thank you. Thank you very much for inviting me to testify about the international impact of the Sarbanes-Oxley Act and the developments concerning convergence of international securities laws. This is my first appearance, and since I do not have the eloquence nor the humor of Sir David, I beg your indulgence. I am extremely honored to meet you again, Chairman Shelby.

Chairman SHELBY. Thank you.

Mr. SHENG. And very honored to meet Senator Sarbanes of the famous Sarbanes-Oxley Act.

[Laughter.]

I must give the disclaimer that the views I express here are my personal views and do not reflect the views necessarily of the Hong Kong Securities and Futures Commission, the individual members of the Commission nor its staff, nor the International Organization of Securities Commissions, IOSCO, where I currently serve as the Chairman of its Technical Committee, nor any of its members.

I am very delighted that the ASIC Chairman, Mr. Jeffrey Lucy, who is a very, very good friend of mine and who is also a member of the Technical Committee, is here this afternoon.

Now, as my testimony is already in written form, I will only take a few minutes to summarize what I consider to be the key points.

First of all, a short introduction to Hong Kong. Hong Kong, a city of only 6.7 million people, is the largest stock market in Asia outside Japan and is the eighth largest market in the world in terms of market capitalization. Most of the major United States banks, investment banks and securities houses, operate in Hong Kong. As of the end of 2003, the securities of 21 companies were traded concurrently on the Hong Kong Stock Exchange, the NYSE, and the Nasdaq. For example, the HSBC Holdings, of which its Group Finance Director, Mr. Douglas Flint, will be testifying later in this panel, HSBC is listed in Hong Kong and NYSE.

Now, the globalization of international financial markets has precipitated an increasing convergence between the Hong Kong market and the United States model of securities legislation. You have asked me to comment on our views of the Sarbanes-Oxley Act. My personal view is that it was a quick, decisive, and effective response to a potential erosion of confidence in the U.S. capital markets resulting from the scandals such as Enron and WorldCom.

Many of us in Asia—actually, you know, I cannot speak for everybody, but I certainly admired and respected the speed, determination, and decisiveness that the U.S. legislature responded to restore investor confidence through the Sarbanes-Oxley Act. The Sarbanes-Oxley Act has heightened awareness around the world of the scope of the directors' fiduciary responsibilities. It has also raised awareness of the need for better corporate governance and auditor independence, the need to improve oversight of the accounting and audit professions, as well as the need to strengthen the protection of investors' interests. It is indeed a landmark and benchmark legislation against all other securities legislation of this type for which the rest of the world has to benchmark against.

Now, market participants tell me that preparation to comply with the certification and internal control review requirements under Sarbanes-Oxley often identify control weaknesses that they would have not noted before. These are areas clearly where Sarbanes-Oxley made a significant and crucial difference, and also an important signal to the market that good corporate governance and auditing matters for deep and liquid markets. I commend you all on the Sarbanes-Oxley legislation.

Our feedback from our industry, however, is that there is some concern over the rising costs of compliance with the increased regulatory requirements, not only in monetary terms but also in terms of manpower and IT development. Some feel—I am only reflecting the views of these participants—that the requirement are restrictive and excessively onerous compared to requirements applicable to corporations that do not have to comply with Sarbanes-Oxley.

However, it would be fair to point out Hong Kong rules and regulations do not conflict with the Sarbanes-Oxley requirements. Hong Kong has similar, though not identical, requirements to Sarbanes-Oxley, such as the requirement for audit committees, responsibility for financial statements, and prohibition of loan to directors.

I would like to say a few words about the growing need for convergence in securities regulation worldwide. In the face of today's globalized markets, regulators must work together to facilitate cross-border listings while maintaining high regulatory standards. There must be—and I totally agree with you, Chairman Shelby—international convergence of securities regulation.

I use the word "convergence" rather than "harmonization" because "harmonization" to me implies that each jurisdiction would have identical or nearly identical rules and regulation. "Convergence," on the other hand, recognizes while there are certain international regulatory principles and objectives that each jurisdiction strives to reach, they may adopt different rules and regulations to achieve the same regulatory goals, such as the frequency of auditor rotation and the composition and duties of audit committees.

Now, Chairman Shelby, as you mentioned quite correctly, and I think, you know, incisively, convergence of regulation promotes investor confidence as their interactions with foreign market participants and issuers are subject to the same regulatory requirements as those in the domestic market. Convergence also allows foreign and domestic issuers to compete on a level playing field. It would lower transaction costs for issuers and market participants who are currently dealing with the varying regulatory requirements of all jurisdictions in which they operate. So it would help contribute to deeper liquidity and better access to capital markets.

Also, the most important, if not the most ambitious, convergence exercise to date is probably the work undertaken by the U.S. Financial Accounting Standards Board, FASB, and the International Accounting Standards Board, IASB, the gentleman to my right, to converge the U.S. GAAP with the international financial reporting standards, IFRS. I personally agree with and fully support such convergence of international accounting standards and commend both standard-setters on their outstanding work.

One of the much debated issues where accounting standards are seeking to adopt common principles worldwide is the issue of expensing stock options. I believe Sir David mentioned this issue. I personally support the proposal to expense stock options because financial statements should reflect the true position of all transactions. In putting the case for this treatment, I do not think I can personally improve on the sage words of Warren Buffett. "If options aren't a form of compensation, what are they? If compensation is not an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

In seeking convergence, the international regulatory community must work together to avoid conflict in regulatory approaches while maintaining high regulatory standards. This can be achieved through bilateral dialogue between two regulatory agencies or multilateral dialogue through international organizations.

An international organization like IOSCO provides an effective forum where securities regulators can exchange views and explore new ideas and approaches to strengthen cross-border securities regulation and cooperation in a coherent manner that closes gaps in regulation, while avoiding duplication or conflicts in regulation.

IOSCO has undertaken several projects designed to improve the regulation of securities markets and the cooperation, especially in cross-border enforcement, among its members. Now, both the SEC and the CFTC are leading and prominent members of IOSCO. IOSCO has issued regulatory standards and principles that have become the principal framework and standards for securities regulation around the world. These principles are not legally binding and do not prescribe a certain type of regulation or any particular regulatory structure; rather, they reflect a consensus among securities regulators on the regulatory objectives in each of these areas. For example, the IOSCO principles governing oversight of auditors and auditor independence, which were issued in 2002, have become the international standard for regulation of auditors.

However, merely converging securities regulations to meet an international best practice is not sufficient as disparities in their implementation can nullify the benefits of convergence. It is essen-

tial that there is some degree of consistent interpretation, application, and enforcement of these regulations to create a level playing field for a truly global market.

The Hong Kong Securities and Futures Commission has a long history of cooperating extensively with other regulatory and law enforcement agencies, including the SEC and the CFTC. We have entered into cooperation arrangements with our counterparts in 33 other jurisdictions to exchange confidential information or to facilitate cross-border investigation and enforcement actions. The Hong Kong Securities and Futures Commission is also one of the 26 signatories so far to the IOSCO Multilateral Memorandum of Understanding, the IOSCO MMOU. The IOSCO MMOU seeks to promote cooperation and information sharing among the international securities regulatory community, especially in the area of investigating and prosecuting violations of securities laws and regulations.

Let me sum up by saying that tremendous strides have been made in many areas in seeking global approaches to regulation. Ongoing consultation and dialogue through international organizations such as IOSCO are critical to the effort to establish the high regulatory standards that the world's investors expect. International convergence of regulations and strengthened cooperation in the enforcement of these regulations together offer the best way of creating a truly global regulatory framework for the global securities market.

Thank you very much for your support and attention.

Chairman SHELBY. Mr. Boyle.

STATEMENT OF PAUL BOYLE
CHIEF EXECUTIVE, FINANCIAL REPORTING COUNCIL (U.K.)

Mr. BOYLE. Thank you, Mr. Chairman. I am honored to have been invited to attend this meeting today to share with you our experiences.

Like Sir David, I am Scottish, but like Mr. Sheng, I have not brought with me any jokes this afternoon.

I would like to draw to your attention three issues from my written testimony. The first relates to the regulatory regime in the United Kingdom. In the United Kingdom, we, like you, share a commitment to excellence in financial reporting and corporate governance. We have recognized that at various times over the last 15 years or so, our regime needed to adapt in order to stay in tune with evolving public expectations, and my written statement describes the adaptations in the United Kingdom, the most recent of which takes into account the lessons from the scandals in the United States and in Europe as we have seen them. And the main vehicle for implementing that adaptation in the United Kingdom is the Financial Reporting Council, which has a wide and perhaps even unique range of responsibilities covering not only corporate governance but also financial reporting, audit, and the oversight of the accounting profession.

Now, we believe that it is important that regulatory regimes add value. We believe that good-quality corporate reporting and governance is a necessary condition for wealth creation. However, as a well-known American once said, it is important to know your limitations. No regulatory regime can eliminate all failures. We believe

that any attempt to implement such a regime would be a wealth-destroying venture.

There is, of course, no ready formula which one can use to determine at what point do regulatory interventions in the market become value destroying. We recognize that point may vary from time to time and may vary from country to country. And in the absence of any such formula, we think it is very important to pay close attention to signals from the market, signals from investors, from issuers, and from other market participants, too.

Time will tell whether the judgments made in designing the new regime in the United Kingdom were appropriate. If they turn out not to be, I am quite sure that further changes will be made. In the meantime, however, we can see that the new regime was widely consulted upon and at present, at least, appears to command widespread support in the U.K. marketplace.

The second issue which I would like to cover is international convergence. Both of the other speakers have referred to this issue, and given the increasingly global nature of the capital markets, this seems a sensible policy standpoint to take. This applies not just to international accounting standards, but also to auditing standards. The arguments which favor convergence of accounting standards apply equally to auditing standards, and in this regard, in the United Kingdom we are not just talking the talk, but we are taking steps this year to increase the convergence of U.K. auditing standards with the international counterparts, and my written statements describes the mechanism which we have used to accomplish that.

However, we do recognize that, as is the case for accounting standards, convergence toward international auditing standards cannot be unconditional. A consensus for convergence is more likely to arise if the standard-setter is independent, follows due process, and is free from political interference.

Like Mr. Sheng, we also believe that if we are to attain the theoretical benefits from international standards convergence, there must also be convergence of monitoring and enforcement. Inconsistent or duplicative monitoring and enforcement both reduces the effectiveness of regulation and increases its costs. And the recent rapid emergence of independent audit regulators, such as the PCAOB in the United States and the FRC in the United Kingdom, is both a threat and an opportunity in this respect. We believe that there should be a mechanism for greater cooperation amongst the international registry authorities in relation to audit, and we are keen to play a role in facilitating this.

The final issue which I would like to comment on is internal controls, and I do so with some trepidation in the presence of this Committee and Senator Sarbanes in particular. We share your belief in high-quality financial reporting, but have not chosen in the United Kingdom to replicate the requirements that the PCAOB has issued in implementing the Sarbanes-Oxley Act. There are a number of reasons for that. First, the position in 2002 in the United Kingdom was somewhat different from yours. There had been in the United Kingdom since 1992 a requirement for listed companies to have regard to their internal controls and for boards of directors to review the effectiveness of those controls. And those require-

ments were further supplemented by the issue in 1999 of some guidance which we refer to as the Turnbull guidance. Our belief is that those requirements had brought about real improvements in the attention paid by boards of directors to internal controls in the United Kingdom. And perhaps it is worth highlighting that when we refer to internal controls in the United Kingdom, we are talking about controls over and above those which apply to the financial reporting process but extend more generally to operational compliance controls and risk management. And we see internal controls as making a contribution to good business management as well as to good financial reporting.

Second, there were, in the United Kingdom, concerns about the cost-effectiveness of the regime as implemented in the United States, and we thought that it would be sensible to delay any changes in this regard and learn from your experience. There is a lot of evidence now emerging about the costs of implementation, but even now it is too early to make a judgment, we believe, because we need to learn not only about the implementation costs, which one might expect would be high, but also about the ongoing costs of maintaining the system in the future.

One factor in our minds is that many examples of financial statement misrepresentations relate to management fraud, senior management fraud, rather than failures in operational accounting. And whereas internal controls can be particularly effective in reducing the risk of operational accounting errors, there are some concerns that they may be less effective in dealing with senior management deception.

We have, however, taken further steps to improve the effectiveness of internal controls over financial reporting in the United Kingdom. First of all, we have strengthened the powers and responsibilities of audit committees, and, second, we have tightened the definition of independence for nonexecutive directors and made it a requirement that only genuinely independent directors participate in audit committee meetings.

Finally, we have just commissioned a review of our Turnbull guidance on internal controls. The group reviewing that guidance contains both executives from business, chief financial officers, auditors, and particularly it includes investors, too. And it will assess whether or not our guidance in this area is still in line with best practice and will reflect on the lessons of implementing Sarbanes-Oxley. And the person we have appointed to chair that group is Mr. Flint from whom you will be hearing later this afternoon. If there is agreement in the United Kingdom that further changes to that guidance are required, then we shall certainly implement it.

I look forward to responding to your questions.

Chairman SHELBY. Thank you for your testimony. We have got another vote on the floor of the Senate, and we are going to recess the Committee for about 15 minutes and come back, if you will be patient with us. We are very sorry.

[Recess.]

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. [Presiding.] We will proceed with questions. The first one is for Mr. Boyle. It is about monitoring and enforcing accounting and auditing standards. Now, my understanding is that the United Kingdom in the last 6 months or so has an independent regulator which you call the FRC. Is that right? Financial Reporting Council.

Mr. BOYLE. Yes. I am privileged to be its first chief executive.

Senator ALLARD. Okay. Very good. Give us some insight on it. I was hoping perhaps maybe you can share with us some of your thoughts on how the Council can be more focused on monitoring and enforcing the standards on a national level.

Mr. BOYLE. Can I deal separately with, first of all, accounting standards? And then I will say a few words about auditing standards as well.

Senator ALLARD. That would be great.

Mr. BOYLE. With regard to accounting standards, as a direct consequence of the welcome developments here but in thinking about how we should respond to that in the United Kingdom, we have made a significant change in our enforcement regime. We have had an accounting standards enforcement regime since around 1990, but it was its practice to operate on a reactive and complaints-driven basis. In other words, people would come to it and say we think such-and-such a corporation's financial statements may not be in order, go and investigate them, please.

We have changed that now to move to an active monitoring arrangement. Proactivity is the buzz word for that we use. And we are on track this year in our first year of proactivity to review 300 sets of financial statements out of a total listed company population in the United Kingdom of around 1,200. And that represents a significant increase in the intensity of our enforcement activities.

Of course, the benefits of having an enforcement activity are not necessarily to be measured in terms of how many sets of accounts are restated. Our intention is to make it clear to chief executive officers and chief financial officers that the risk of your misstatements now being caught is high and that will reduce the number of cases that we actually need to require changes to the financial statements.

With regard to auditing standards, we have set up for the first time this year an independent audit inspection unit which is, right now, in the offices of three of the big four accounting firms in the United Kingdom. We will shortly be visiting the fourth one. And their work program is such that they would expect to spend somewhere in the region of 9 months of each year reviewing various aspects of the way in which those audits firms conduct their work. Those would include whole-of-firm procedures, including the tone at the top, including the basis for partner appraisal and remuneration, including quality control and risk assessment procedures in those firms, and, in addition, taking the audit files for individual financial statements and reviewing the way in which those audits were conducted, not merely from a process point of view but also reviewing the appropriateness of the judgments made by the auditors in relation to those financial statements.

Again, this is a significant increase in the intensity of enforcement of auditing standards in the United Kingdom.

Senator ALLARD. How do your accounting standards compare with what we have in this country? And how do your auditing standards compare with what we have in this country?

Without getting into a lot of detail.

Mr. BOYLE. I will not get into a lot of detail, particularly in the presence of Sir David, because before he took over as the Chairman of the International Board, he was for 10 years Chairman of the U.K. Accounting Standards Board, so he is actually the best person to describe the U.K. model. It is in many respects similar to that which is used in the United States, but in addition, we have a clear commitment in the United Kingdom to converge to international standards as soon as we are permitted to do so by the European Union. I would say in general the standard in the United Kingdom tend to be less voluminous than the FASB standards, but we would like to think they are of a comparable effectiveness.

In terms of auditing standards, again, I think we could hold our auditing standards up for favorable comparison with those in the United States. All of the important topics that you would feel should be covered in a set of auditing standards are covered in our auditing standards in the United Kingdom, and we have, as I explained in my written testimony, got a convergence program of our own to move our standards more into line with international auditing standards, but with the important qualification that where we think there is already in the U.K. literature an important matter which is not covered in the international standards, then we would supplement the international standards to retain that requirement.

Senator ALLARD. What do you see, Sir Tweedie, as the biggest problem in moving toward convergence?

Sir DAVID TWEEDIE. I think the biggest problem is going to be the principles versus rules issue. We have agreed with the SEC and the FASB that we will actually harmonize and converge at the principles level.

Now, the idea then is we move on to start writing joint standards. We will give the pen to one member, be he an American or one of our staff members, and the question then is what detail is going to appear in that? And the real question I think is going to be the litigious nature of the U.S. environment. That is going to be our real problem, because the accounting firms I think, not unnaturally having watched what happened to Andersen, are looking for defenses, and therefore, if you have a rule it is easy to say, well, it says here you cannot do this, where principles are going to involve judgment, and you will get one or two wrong. It is bound to happen.

In the United Kingdom if that were to happen, the defense would be that the judgment, which would be documented, was made on reasonable grounds and, okay, with hindsight you could say it was wrong, but at the time that was a fair judgment, and that would get you off in court. It is only if it is negligent that you would be in trouble. So, I think that is the attitude now. Of course, the U.S. courts, I am not sure how they would react, and that is going to be one of the big issues.

Senator ALLARD. I would agree with that because I have had a chance to visit with some individuals from the various European countries including Great Britain, and the principles versus rules seems to be the big issue out there. It is a fundamental concept.

Is the rest of the world on principles and we are kind of out here by ourselves on rules, or is there other countries that have set rules like we do, and follow our general process that we have in America?

Sir DAVID TWEEDIE. I think you are really on your own. It is not as though the American standards are not based on principles, they are, but you have an awful lot of application guidance, and that is the real problem. One of the difficulties I think is if you have a rule-based system, you can get caught because people can just obey the rules, and I think some of the issues that occurred around the time of Enron were classics. It is far harder to get past a principle. And if you have a rule, for example, that says if A, B, and C happens, the accounting is X, we know the investment bankers will come up with B, C, and D, and then we have to have another rule to cover that. Whereas if you have a principle, and use A, B, and C as an example, you have caught the lot, and I think it is much more effective.

So the rest of the world is actually on that basis.

Senator ALLARD. Here is the question I think that is probably the most important of all to ask. The other ones have been just background kind of laid out there. But what are the essential guidelines that we need to have to have consistent across the borders for a healthy system with international trade? When I use that "healthy system," I think investor confidence, and assurance that you are going to get what you pay for type a thing. What are the essential elements that we need to have there?

Sir DAVID TWEEDIE. I think what this Committee did has a lot to do with that. When the crises first happened, we heard all over the world that American standards, supposed to have been the best, and now look what has happened. And then when the dust settled, it turned out of course that it was not the American accounting standards, it is the way that people had actually twisted them and done it. That is where I think the confidence came back again.

The reason for our existence in fact is exactly the point you made. When we had the financial crisis in Asia in 1997, companies collapsed without warning, and the accounts looked all right, and that is when they felt it was going to take 5 or 6 years to put new standards back. It was not corporate governance, it was bad accounting in those days. And that is why they went for these international standards.

The reason they go for them, and New Zealand was a classic, it has two or three very good standards we will probably make global standards, but they decided to sweep them all away and take international, because what they did not want was inward investment coming and saying, well, we are almost the same as international standards, because they felt they would lose the advantage of the confidence that people knew exactly what they were going to get as opposed to have various nuances that were New Zealand related.

I think the key issues is if we can get these basis principles agreed between the United States and ourselves, corporate governance, which is a critical issue which really failed in America, and that is what you have repaired, and that is the real issue, is lack of confidence in the market, which is a big problem, and there is confidence in the U.S. markets.

Senator ALLARD. I will turn the Committee over to Chairman Shelby.

Chairman SHELBY. [Presiding] Thank you, Senator Allard.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I want to thank the members of the panel for their testimony here today.

Sir David, the status of the present program, as I understand it, is that the EU would adopt the standards of the International Accounting Standards Board next year, is that correct?

Sir DAVID TWEEDIE. Yes.

Senator SARBANES. Are many other countries also adopting your standards?

Sir DAVID TWEEDIE. Yes, the estimate is 92 going in that direction, and they are really growing all the time. Russia is there. China is coming. They have stopped doing their own standards. They are gradually starting to bring international standards in. Hong Kong is changing on January 1 of next year, and New Zealand, Australia, all of whom have their own standards board are just stopping and they are actually using our standards. The reason I think is exactly the point that was made earlier, it is for cross-border trade, the fact that if you know what you are getting, the investment risk disappears, or at least one of them, the accounting risk disappears.

So the idea really is they had a choice. Do they do U.S. standards or they do international standards? Some countries, Latin America, look more toward the United States. That is one of the reasons they are keen on convergence too. If we bring the two big standard-setters together and have the same basic principles, then globally we will have the same accounting. We think we can probably do that by the end of the decade.

Senator SARBANES. I take it from your testimony, I noted you said there was a once-in-a-lifetime opportunity, I think was the way you put it? Was that the phrasing you used?

Sir DAVID TWEEDIE. It was.

Senator SARBANES. So that if we work through this skillfully, we could have one set of accounting standards worldwide?

Sir DAVID TWEEDIE. That is the intention.

Senator SARBANES. The monitoring and implementation of them is of course a separate question, but at least the standards would be a worldwide standard.

Sir DAVID TWEEDIE. That is the idea. I think it was the fact that after Enron we all realized that we could not risk having a trading down of accounting standards and we had to pick which one was the better one, and that is in a way why we signed the agreement. We are also lucky, of course, that the FASB and the SEC were very enthusiastic.

Senator SARBANES. They are very strongly committed to the convergence process, I know.

Sir DAVID TWEEDIE. They are very strong.

Senator SARBANES. I know. It has strong support amongst many Members of the Congress, so I wish you well in that endeavor. I am going to move on because we only get a limited time here.

Mr. Boyle, obviously, I have to rise to the bait on the 404. I want to quote some excerpts from two articles that appeared in the *Financial Times* on August 25 and one in *The Wall Street Journal* on July 2. The *Financial Times* concerning Royal Dutch Shell.

"The U.K.'s Financial Services Authority and the U.S. Securities and Exchange Commission yesterday issued their findings into wrongdoing that led Shell to admit in January they improperly booked 20 percent of its oil and natural gas reserves. Auditors of Shell's reserves warned the company as early as January 2000 that its reserves figures may have been overstated. The SEC is scathing about Shell's advice to investors that it had changed its mathematics to recalculate reserves, saying in its 1998 annual report only that estimation methods have been refined." Interesting choice of words.

"Shell's decentralized system required an effective internal reserves audit function, both regulators write. Shell had engaged as a group reserves auditor, a retired Shell Petroleum engineer who worked only part time and was provided limited resources and no staff to audit its vast worldwide operations."

The Wall Street Journal article on Nortel. "Nortel's board is determined the company inaccurately employed an accounting maneuver that made it look profitable when in fact it wasn't. In some cases the dollar amounts of the many individual moves were so small they were almost impossible to detect. In filing a detailed restatement of 3½ years of financial results, Nortel's auditor said the company had material weakness in its internal controls."

And in light of the situation that apparently arose at Shell and at Nortel, why would you think that attestation and audit of a company's internal controls is unnecessary? Would this not suggest that this experience of these companies and others that could be named suggest that directors who rely on management for internal control assurances are in the same position as directors who insist on internal and external review of the adequacy of controls? Does it not underscore actually the need for a strong internal control system?

Mr. BOYLE. We absolutely believe in the benefits of a strong internal control system, and as I mentioned in my testimony, there has been a requirement for boards of directors in the United Kingdom since 1992 to review the effectiveness of their internal controls.

I think I also mentioned in my testimony that in many cases of financial statement misstatements, the overriding factor has been a deliberate attempt by the senior management to misrepresent the company's true position, and it remains to be seen whether or not those deliberate misrepresentations are best dealt with through internal controls or not. There is a serious danger that even the best internal control systems can be overwritten by senior management, and the question that we have to decide on in the United

Kingdom, which we have not come to a final decision yet, is, is it cost effective to put in place a detailed system of audit of internal controls? Is that additional cost appropriate, and does it deal with the principal source of the difficulties in the cases you refer to?

We have not yet come to a definite view on that, and I would say at this stage though, in the U.K. context, we have not had pressure from investor organizations to put in place a model which replicates the requirements in the United States.

Senator SARBANES. Are you suggesting that you are already doing much of the 404 under the existing regime?

Mr. BOYLE. Absolutely, there is already a requirement for companies in the United Kingdom to undertake an annual review of the effectiveness of their internal control systems, not just their controls over financial reporting, but their broader operational and risk management procedures, and it is already the practice in the United Kingdom for much of that internal control review to be documented in order that the management of companies can give assurance to the audit committee and the independent directors that they have a reasonable basis for saying that they have reviewed the internal controls.

What we have not done is specified the detail of how companies should document those requirements, nor have we required auditors to attest to the effectiveness of those controls.

Senator SARBANES. Obviously, we have that requirement. We are working through it now. The General Electric people, let me just quote what their finance chief, Keith Sherin said. "The absurd aspect of this backlash against Sarbanes-Oxley is that companies are finding out that tightening their internal controls is actually good for their business. We have seen value in the 404 work. It helps build investors' trust and helps give them more confidence. We have gotten positive benefits from it." And he went on to say that of their expenditures to implement it, about two-thirds of that money is spent on its own employees, and he says, "I consider that to be a good investment."

There are others who have said much the same thing. It is interesting that it seems to be breaking into two camps. One camp sees it as an opportunity to really strengthen the internal operations of their company and reap benefits from it and come at it with a very positive attitude in terms of the benefits it can bring. Others, of course, are resistant and are complaining bitterly about it, although as Paul Volcker and Arthur Levitt pointed out, the ones complaining the most are companies that for too long have lacked adequate internal controls, and therefore the requirement for them requires a major change in how they do their business.

Mr. BOYLE. And if I may say, in the United Kingdom, following the publication in 1999 of our Turnbull guidance, there was initially quite a lot of resistance from companies as to the additional cost that would be imposed at that stage. However, I think the general consensus now is very similar to the experience which you are now having in the United States, which was the companies have indeed benefited from a greater focus on internal controls, and the requirement for companies to document that internally has led to the identification of weaknesses and to improvements, and those

requirements have been in place in the United Kingdom for a number of years.

What we have not done, however, is to take those requirements which are—if you look at the Turnbull guidance, at the level of principal—I think the Turnbull guidance itself is around 15 pages in length—we have not specified in detail precisely how that assessment and documentation process is to be conducted, nor have we found it necessary at this stage at least to acquire auditor attestation of that.

Senator SARBANES. Mr. Sheng or Sir David Tweedie, you have any comments on this point?

Mr. SHENG. If I may say, in the U.K. type tradition, actually attestation of the financial statements is already built into the system in the sense, for example, in my Commission's financial statements, I as chairman actually sign it together with the chief financial officer, would have to attestate that. It is not required by law, but by sheer practice we do do that. There is a slight difference in the sense that all board members under the U.K. type, of which the Hong Kong companies ordinance follow, all directors are jointly and severally liable for the accuracy of the accounts. So it is already built in into the law. We have to attestate and we are liable.

Where I think the Sarbanes-Oxley is more specific, it puts the individual responsibility on the person who attestates.

Senator SARBANES. Did you want to add anything?

Sir DAVID TWEEDIE. I just think what Andrew said is absolutely true. The auditors of course do examine the internal controls, and it would be interesting to see what extra cost it would be to actually comment on that. They may not wish to, but it would be interesting to see what the cost would be. And a statement put out by the directors, which they do internally, I would not have thought would be a massive extra cost, but I am sure Mr. Flint will tell you what he thinks about it. But in my own view, I would not see where the massive costs are coming, and the benefits of course are huge.

Senator SARBANES. Thank you, Mr. Chairman. I just want to make the observation to Mr. Sheng that I understand that the Hong Kong Securities and Futures Commission, you have historically had a very good working relationship with the SEC on both enforcement matters and information sharing matters, and obviously we think that is quite important, and I just wanted to put that on the record here today.

Mr. SHENG. Thank you.

Chairman SHELBY. Thank you.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

I mentioned in my opening statement that I had quite an interest in the small businesses, and I want to congratulate IASB on the commencement of their initiative for small- and medium-sized enterprises. I applaud that effort.

It is my understanding that substantially more small- and medium-sized businesses require certified financial statements than in the United States. Could you give me some background on how this project got started, how it is going, and where you expect it to go?

Sir DAVID TWEEDIE. When I was at the U.K. Standards Board, we have a million companies in the United Kingdom, of which only about 3,000 are listed, but nonetheless, almost all the others had to produce accounts and there are some exemptions now with the smaller ones, but very small. And we felt that we were writing standards really for the capital markets and not necessarily for the smaller companies. The question was the sheer burden on these companies. The book of standards, which was not as big as obviously the U.S. standards, but nonetheless was a volume. Could we shrink that? What we tried to do is, what we are experimenting with internationally, can we actually look at these standards, extract the main principles from them, then decide is there anything else that as a small business you would require to operationalize this standard. And are the disclosures that are really needed or just for the main investors, because the banks obviously can ask for them. So we managed to slash down the size of these standards. We have done the same experiments internationally. Our pension standard, which at present is 80 pages, we took down to 8. Of course, that raises the question whether you need 80 pages for the main one anyway, and that is the second stage, I suspect.

[Laughter.]

We genuinely believe we can. We are holding broadly the same principles in the standards for measurement, and if there is some cost benefit of having an approximation, well, let us do that, but cutting a lot of the disclosures, and a lot of the issues that are raised in the standards for the capital markets really are not very relevant, so we have taken those out.

There is a little note that says if you want further guidance you can always go look in the other standards, but basically we hope that we will have almost a self-contained set of standards for smaller companies.

Senator ENZI. I do appreciate that, and would be interested in knowing some of the differences between the big businesses and the small businesses. I will not ask that now because we have a very limited amount of time.

Instead, Sir Tweedie, I would rather move on to a little different topic, and that is that given the fundamental differences between the United States and the European tax systems, would you not agree that the current IASB proposal to harmonize the accounting treatment of deferred taxes is at odds with the strategic objectives of IASB's convergent project?

Sir DAVID TWEEDIE. We will debate them, and I am not quite certain which bit you are referring to. My views on the American and international taxes standards are fairly well know, and I think both of them are dreadful, but we are stuck with them. Basically, there is an issue that I do not particularly agree with in the international one which is going to be debated with the FASB, but we have not made any decision on it, Senator, and it will be interesting to see where we end up on that.

Senator ENZI. But you would not be considering them dropping that from your short-term convergence project?

Sir DAVID TWEEDIE. I think we are trying to get it together, but I think the issue to which you are referring, which I think is overseas problems, that is going to be a big debate we are going to

have. We have not made any firm decision on that. We may have to shift.

Senator ENZI. We have a few tax issues before the U.S. Senate right now dealing with international trade too that we have not quite worked out.

Mr. Boyle, it is my understanding that the United Kingdom is balking a little bit at the accounting standards as they apply to mergers. Can you give me a little bit more background on that?

Mr. BOYLE. No.

Senator ENZI. Okay.

[Laughter.]

Mr. BOYLE. I am really not sure what lies behind your question. My understanding in the United Kingdom is that we are 100 percent signed up to the convergence project, and indeed, in the discussions which have been taking place in Europe in recent months over their endorsement of the International Accounting Standards Board, the United Kingdom has been in the lead in arguing for full and immediate adoption of the complete set of international standards. So we do not currently have any concerns about the international standards, and we do not have any particular concerns on measures. There was a major reform of accounting relating to marriages and acquisitions, pushed through by Sir David around about 10 years ago to eliminate some of the abuses on marriage accounting, which had in fact been at the heart of some of the proper scandals in the United Kingdom in the late-1980's. That issue was resolved at that stage and I am not aware of any new issues arising.

Senator ENZI. My information came from an article on April 29 of this year, and I was just going to get into some of the difficulties of convergence, but I assume that we will get to do some written questions and probably more detail.

Chairman SHELBY. We will. We will leave the record open.

Senator ENZI. But I would like to know a little bit more about some of those difficulties because we have a few mergers in the United States too, and I want to see what the difference is. So thank you.

Chairman SHELBY. Thank you.

Regarding specific implementation issues, has there been an open dialogue regarding accommodations that may be necessary for foreign entities?

Mr. Tweedie.

Sir DAVID TWEEDIE. We have not actually made many accommodations when we are comparing the various standards with those of the United States. If we are talking about the international capital markets, we have to have the same thing, so there has not really been any. There has been the odd little transitional arrangement, but nothing much.

Chairman SHELBY. How do international regulatory bodies address the differences in the standard, divergent applications for a particular standard? We talk about the best standard and so forth. How do international bodies address those differences and ensure consistent application of standards, which is what we are trying to get at?

Sir DAVID TWEEDIE. One of the areas we have come across is where we have a different interpretation that has been taken place,

let us say in Europe compared to United States. That will be picked up almost certainly by the local regulator, and he may have to make a quick decision, but once there is discovered that there is this difference, we would be notified, and then together with the U.S. Emerging Issues Task Force, we would issue a joint interpretation, or we will change the standard to make sure it is crystal clear, but that is how we try and stamp them out.

Chairman SHELBY. What is the status of the international debate regarding the fair value accounting treatment for derivatives?

Mr. SHENG. This is very controversial at this stage.

Chairman SHELBY. Very complicated.

Mr. SHENG. Sir David is on top of it.

Sir DAVID TWEEDIE. Or underneath it.

[Laughter.]

Chairman SHELBY. All over it, in other words.

Mr. SHENG. All over it. I think I am all for convergence in this area, and I think it is very, very important that, particularly in this area of reporting on derivatives, it is pretty important that we have one consistent standard around the world. It is my firm belief that timely and access to accurate accounting information is a market fundamental, and without a consistent standard applied globally, we are not going to get that.

Chairman SHELBY. Mr. Boyle, do you have any——

Mr. BOYLE. No. If I may just elaborate. In the European context in terms of your previous question about enforcement, one of the benefits of the tighter integration of the markets in Europe is that there is now agreement between the enforcement organizations in Europe for close cooperation on implementation issues such that they are in fact now proposing to construct a database of interpretation issues which will be accessible to all of the national authorities in Europe such that when they are faced with an enforcement question, they can consult the database looking for precedence to see has this issue arisen in another country? They can then have a dialogue with the appropriate authorities in that country to understand why they took the view they took on enforcement, and that would help, we believe, to reduce the divergence of implementation enforcement.

Senator SARBANES. Is there going to be an EU enforcement mechanism?

Mr. BOYLE. Because of differences in securities and company law in each country, it does not make sense to have a single European enforcement mechanism. So the alternative which is intended to achieve similar benefits, is very close coordination of the enforcement activities of the individual national enforcement authorities. And it is for that reason that this interpretations database is being constructed, and there is already a committee of European enforcers which meets from time to time to discuss how they will be handling these important enforcement issues.

Senator SARBANES. What is the mechanism by which the coordinating body pushes a country that is lax in its enforcement amongst the EU? I mean you could have a situation in which 22 or 23 countries are all enforcing at a very good standard, and a couple have fallen off the shelf. How do you get them to where they should be so they do not constitute this opening for lax practices?

Mr. BOYLE. The mechanism for the responsibility for ensuring that there is consistent enforcement activities, and for dealing with poor enforcement, rests with the European Commission itself. They have that general responsibility in relation to all European directives. The regulation relating to International Accounting Standards is a European-wide regulation.

I have to say, the challenge of making sure that all these European regulations is enforced is a massive one, and we should not underestimate the difficulties of achieving that, nor necessarily where this would come on their list of priorities. But we are hoping that we can have a sharing of best practice and there will be, frankly, peer pressure amongst the different national regulators to raise their standards to a high level, but ultimately the European Commission would thus have the right to intervene and take issues up with national authority.

Chairman SHELBY. I want to take a moment and thank all of you for coming so far, and to participating in this hearing today because I think it is very important to Senator Sarbanes and others on the Committee. We have had the opportunity to meet with you, various parts of the world on these issues. We will continue to work with you and the SEC and our counterparts. I think the goal is to have an international standard we can all work by, and our investors know what the standards are. Is that basically correct?

Mr. BOYLE. Thank you.

Chairman SHELBY. Thank you so much, and we will move to the second panel.

The second panel, I will announce it again. Mr. Douglas Flint, the Chief Financial Officer, HSBC and a member of the U.K. Accounting Standards Board; Mr. Arnie Hanish, Chief Accounting Officer, Eli Lilly & Company; Mr. James Turley, Chairman and CEO of Ernst & Young, LLP; Mr. Greg Bentley, President and CEO of Bentley Systems; and Mr. Len Moodispaw, President and CEO of Essex Corporation.

Senator SARBANES. Mr. Chairman, I would like to welcome Mr. Moodispaw in particular. He is President and CEO of Essex Corporation, a small public company headquartered in Columbia, Maryland that provides a specialized technological assistance on communication issues, primarily to the Defense Department and our intelligence agencies. They have grown from 45 employees and $4.5 million in revenues in 2002 to 240 employees and an estimated $60 million in revenue in 2004. It is a commendable performance, and I wanted particularly to bring it to your attention.

Chairman SHELBY. You have some up and coming constituents.

Senator SARBANES. Yes, we do.

[Laughter.]

Chairman SHELBY. All of your written testimony will be made part of this hearing record without objection, and if we could, because we do not know when we are going to be interrupted here on the floor because we have the Homeland Security Appropriations Bill before the Senate, we will be voting.

Mr. Flint, we will start with you. If you could sum up your comments as quickly as you can, we appreciate it, since we have the benefit of your written testimony.

STATEMENT OF DOUGLAS FLINT GROUP FINANCE DIRECTOR, HSBC HOLDINGS PLC

Mr. FLINT. Thank you very much for the opportunity. The views I express are personal, but they are very important to HSBC, not only in our own capacity as a major registrant and one of the largest financial groups in the world, but also as corporate governance impacts very much the investments and lending activities we have, and it is clearly important that the environment in which we operate has sound governance and transparency.

There is absolutely no doubt in the couple of years there has been huge attention given to governance, in the first stage substantially over the role, the caliber, the independence of directors and the construct of the board. But the Sarbanes-Oxley Act was a welcome wake-up call, an essential wake-up call, reinforcing the accountability of the board, the responsibilities of the board, and making them clearly defined in the area of financial reporting. Probably as important as the Act in defining those responsibilities and accountabilities have been the actions taken against those who have transgressed in terms of the penalties, as all of us are now acutely and regularly aware of the penalties of failure, and I think reinforced not just by the bad names that we all like to distinguish ourselves from, but some in recent years, regrettably some of the marquee names that were historically thought to be beyond that.

I think the issue that I want to spend a little bit of time on is that while governance is undoubtedly recognized as the responsibility and accountability of directors, there are some issues in implementation namely how to evidence compliance. Now, this is not a Sarbanes-Oxley issue, in my view, because Sarbanes-Oxley is very, very clear. It has to do with the implementation guidance and the way that implementation guidance is being interpreted.

Given that boards increasingly are having to be, and rightly so, selected for their independence and experience, there is perhaps a danger that the process is becoming the end rather than the means to the end. And there is absolutely no doubt—and I would share the comments of Keith Sherin at GE—that there are aspects of documentation under 404 that are necessary, and indeed essential, and I think we all stepped back and thought about whether there were aspects of the way we put accounts together where we could do more to demonstrate to ourselves that we are getting it right.

But the interpretation that currently is about, that requires all control systems to be documented in a way which they were never designed to be done, in terms of attributing commercial control attributes to the controls themselves, I believe in some way risks devoting a disproportionate resource to documenting systems where there has been no history or expectation of weakness, rather than devoting the same amount of resource to the areas where it is believed that more attention could usefully be given.

This is not a cost issue, although it is costly. We, in the banking industry, are not only coping with the implementation of international accounting standards, which is a significant challenge, but also Basel II, where the costs are significantly higher, but the benefits I think are clearly to be seen.

In terms of practical issues, there are a number of things that are beginning to concern us a bit. It is clear from discussions we

are having with all the accounting firms that the absorption of their resources around the world is intense, and I think it is perhaps good for us and perhaps good for U.S. registrants also, that foreign registrants have a year's delay, because I am not quite sure there is enough resource to do us all at one go anyway.

Across geographies there are implementation challenges. I think in the United Kingdom and the United States the tradition of auditing was fairly similar and auditing standards were similar, but once you move outside of those territories, there is inconsistency within the big firms as to how they are interpreting the requirements of Sarbanes-Oxley.

The control frameworks in many countries are less well formalized, but not necessarily less effective in practice, and that is causing implementation challenges, because while directors clearly are responsible and accountable and recognize that, for the risk of such a control framework, I do not believe they should feel constrained to accept that type of risk because of the rigor imposed of a single model of documenting controls.

I worry a little bit in my position as Chief Financial Officer about the concerns that I have to assuage of accounting officers around the world who are faced with having to account in local GAAP, move that into U.K. GAAP, prepare for international GAAP, and provide the information to reconcile to U.S. GAAP, against a framework where people are saying the penalties for getting it wrong can be extreme. It is an extraordinary burden to have to cope with four different sets of accounting requirements, and I will come on to that in the international accounting piece.

I would hope that at some point as this develops, that there would be an opportunity to consider mutual recognition of approved governments' regimes as part of the compliance or the interpretation of compliance with Sarbanes-Oxley.

A few words on the international agenda. We clearly welcome everything being done to perpare for a single language of accounting. We are listed on five stock exchanges. We produce accounts in 76 countries. The burden of tracking various GAAP's and training people is huge. We have a commitment to harmonization. Clearly, all rules will not suit all people at all times, but the benefits from a single framework are well beyond individual gripes about individual aspects of standards.

I had a meeting, when I was in Washington yesterday, with the SEC, and I really do feel encouraged that the harmonization agenda is shared, but the more that could be said to evidence that to the non-U.S. constituents I think would be very helpful.

A couple of last words on the auditing situation, which I think is again of interest and of some concern. In terms of auditing standards, it would be good if we could achieve global convergence on rules on independence and if we could have a global solution to liability. I think in that regard, one issue that concerns us is the challenge that David Tweedie mentioned—the debate between principles and rules and the understanding that rules give more of a safe harbor as to how things are done in a particular way.

But today we are faced with sometimes unintended consequences of perverse but literal translation of accounting language that was never designed for the circumstances in which it is being applied,

and I think it would be good if there were overriding guidance that would take people away from perverse literal translation of accounting rules to the principles that the accounting standards were addressing.

That leads to a worry that today I believe more than in history that auditors are being trained more in control evaluation and GAAP application, rather than how to stand back to understand whether the consolidation of the accounting information that has been put together makes sense because it is in my view still the case that the aggregation of GAAP from within robust accounting systems is not necessarily going to give accounts always that are the best communication of the business enterprise being described.

I think one thing that I would like to see international attention given to, just as the SEC made tremendous strides in the MD&A in plain English, would be if the accounting and auditing profession with guidance could make a plain English audit report so that those into that read it could understand what the auditors actually did and what objective they were seeking to get to.

Thank you.

Chairman SHELBY. Thank you.

Mr. Hanish.

STATEMENT OF ARNOLD C. HANISH CHIEF ACCOUNTING OFFICER, ELI LILLY & COMPANY

Mr. HANISH. Thank you, Chairman Shelby and Ranking Member Sarbanes.

My name is Arnold Hanish, and I am the Chief Accounting Officer for Eli Lilly & Company, and I am here this afternoon as the Vice Chairman of the Financial Executives International Committee on Corporate Reporting. FEI is the leading advocate of the views of corporate financial management representing financial executives such as chief financial officers, treasurers, and controllers.

FEI strongly supports the spirit and goals of Sarbanes-Oxley, as it has strengthened the ability of financial executives to institute continuous improvements in internal controls and financial reporting, and to gain enhanced buy-in by all employees of the need for strong internal controls. In fact, FEI was one of the first business organizations to provide constructive recommendations to Congress on improving financial reporting and corporate governance.

One of these recommendations requiring audit committee financial experts, now Section 407 of the Act, has succeeded in having audit committee members better understand and participate in the company's corporate governance process. It is because of Sarbanes-Oxley that audit committee members are much more actively engaged, all positive outcomes.

At my own company, Eli Lilly, we have held numerous education sessions for members of our audit committee in order to build their awareness of important and complex accounting reporting issues and their financial accounting expertise.

We also would like to acknowledge the regulators' efforts to provide implementation guidance for their internal control related standards, and appreciate the recent comments of regulators that adequate time be allowed for implementation of new standards in the pipeline.

That said, documentation can supplement, but will not supplant, judgment and honesty of the audit committee, the board of directors, or senior management. This is the area in which FEI would like to stress the fundamental concept that has held the test of time, which is generally referred to as substance over form. In the rush to implement Sarbanes-Oxley, there has developed what seems to be an overemphasis on certain additional or duplicative levels of documentation with a declining value in terms of how much that additional documentation adds to the effectiveness of internal control.

Let me give you an example. If a meeting of a company's disclosure controls committee is held to discuss a financial reporting matter, in our new post-Sarbanes-Oxley world, there can be so much focus on testing by the auditors for documentation that the meeting was held, that there is insufficient attention paid to reviewing the substantive nature of what was discussed, and the reason why the meeting was held can be overshadowed by the need for a piece of paper documenting the meeting. This really just does not make much sense.

In grappling with implementation of the Act, some companies are falling into the trap of stressing substance over form, which ultimately does not benefit the reliability of internal control, and as a result does not advance the intent of the Act. Make no mistake about it, documentation for documentation's sake will not deter financial fraud. In reality, the increased sentencing guidelines will probably provide the single most important disincentive for committing financial fraud.

As we all move to implement the SEC and PCAOB standards under the Act, we must remember that documentation should supplement but not supplant management's judgment, integrity, and honesty.

FEI has been surveying its membership on the costs for implementing Section 404 of the Act. I have attached a copy of FEI's January 2004 and July 2004 survey results to my testimony. In July, FEI surveyed 224 public companies with an average revenue of $2.5 billion to gage the compliance cost estimates. The survey results showed the total cost of compliance with Section 404 is now estimated at over $3 million for the average company. This represents a 62 percent increase versus an earlier estimate from our January 2004 survey of almost $2 million for the average company.

While all companies are feeling the impact of the Act on their bottom line, FEI recognizes the concern about the impact the statute will have on smaller companies.

I am fortunate to have a staff of extremely competent CPA's with anywhere from 5 to 14 years of public accounting experience, but many smaller companies do not have that luxury. Although the FEI July survey did not indicate a disproportionate impact on smaller companies, logic tells me that this is an area that should be closely monitored for a burden that may be too great and where costs are disproportionately higher.

In closing I would like to tell you a story about the founder of my company, Colonel Eli Lilly and what I believe he might have thought of the Sarbanes-Oxley Act. A veteran of the Civil War, Colonel Lilly was also a pharmacist. He was concerned that people

were purchasing purported medicines with no verification of safety or effectiveness. In response to the state of affairs, Colonel Lilly chose to start his own company. His goal was to provide medicines that passed high standards and protected the public's health, safety and interest. He further believed that medicine should be most properly purchased on the advice of doctors, not from traveling salesmen.

From the beginning, innovation, quality control, and its counterpart, internal control, have always been a part of Lilly's tradition. So if Colonel Lilly were here today, my guess is he would probably applaud the Sarbanes-Oxley Act for its emphasis on internal controls in providing greater quality assurance in financial reporting. He would recognize the role of the external auditor in providing third-party independent attestations on these financial reports.

But he would also remind people of the importance of innovation. We cannot lose sight of the forest for the trees. We must not let internal control testing and related documentation take over so much of our time that we lose focus on the operation of strategic planning of our key products and services.

This concludes my remarks. I would like to thank the Chairman and Members of the Committee for allowing FEI the opportunity to testify. Thank you.

Chairman SHELBY. Thank you very much.

Mr. Turley.

STATEMENT OF JAMES S. TURLEY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
ERNST & YOUNG, LLP

Mr. TURLEY. Thank you, Chairman Shelby, Senator Sarbanes, and Members of the Committee. I am Jim Turley, Chairman and CEO of Ernst & Young, and it is a great pleasure to be here with you today.

In consideration of time, I am going to provide some brief comments, but would certainly refer you to my written testimony.

Let me simply say at the outset that the Sarbanes-Oxley Act is working. It is having a positive effect on the behaviors of auditors, audit committees, corporate management, and others. The Act has allowed investors to put a wall between the corporate and accounting scandals of the past and financial reports in the future.

The Act has brought about historic change as 100 years of self-regulation of our profession has been replaced by the Public Company Accounting Oversight Board. As I have said many times, both publicly and in print, I truly believe that the formation of the PCAOB will prove over time to be one of the best things that ever happened to my profession. A tough but fair and independent regulator will make our firm and the entire profession better.

As I noted, behaviors have significantly changed within accounting firms, in audit committees and in corporate management. First, inside the accounting firms themselves, the changes that are taking place are substantial. In my written testimony, I detail many of the efforts we have undertaken at Ernst & Young, all designed with improved quality as the objective. Audit committees are now in charge of the auditor relationship. They hire and fire us. They evaluate our performance, and they scrutinize each and every serv-

ice we deliver before we deliver it. This is the audit committee approval process that Sarbanes-Oxley called for.

It is well known that audit committees are today meeting more frequently and in significantly longer meetings. What is less understood, and in my opinion, more important, is that it is not just the quantity of meetings that is increasing, it is also the quality. Again, my written testimony expands on this.

The Act has also changed management behavior. Among other things, the CEO and CFO certification requirement has driven very positive changes through the ranks of corporations, cascading accountability for financial statement accuracy to all business units in all parts of the globe. From my vantage point, there is real reason for investors to have greater faith in the integrity of financial information and in the capital markets.

There are, however, other lingering challenges that the accounting profession is focused on addressing. Our profession has struggled for years with expectation gaps in two important areas. There is an expectation gap between the amount of fraud detection that the public expects and the level of assurance that an audit is designed to deliver. The other gap, which has received substantially less attention, relates to the precision of financial reporting itself. Financial statements, in fact, are based on many educated estimates and judgments. Unfortunately, the expectation exists that financial reporting is a very precise science.

The profession for years has felt that if only investors could be educated about the limitations of financial reporting and auditing, these gaps would go away. It is clear to me and it is clear to others in my profession that better education of investors is not enough. We need to work with the PCAOB to strengthen the profession's ability to detect fraud and more clearly identify the judgments and estimates that underlie so much of today's financial reporting.

Obviously, all of this has to be done with a proper balance between costs and benefits to investors.

The new internal control reporting requirement under Section 404 provides investors, in my opinion, with greater transparency into the strength of a company's internal controls, and I think this is really a significant benefit. I am concerned, however, that when the Section 404 reports come out in early 2005 the benefits that come from increased transparency could be diminished because too few investors may be able to interpret what the findings mean. Absent additional guidance or information, investors and others may misinterpret and overreact to an assessment that a public company's internal controls warrant improvement. Some may even wrongly equate an internal control weakness with financial statement inaccuracy, and there may even be more material weaknesses and internal controls, and more adverse opinions than people originally imagined.

For that reason, I believe a shared education effort among our profession, the SEC, the PCAOB, issuers, and investors is needed around the new internal control reporting process and how to interpret findings and responses. The major firms are committed to working with others in such an effort.

Before closing, I would like to briefly address the recently released PCAOB inspection reports. Let me simply say that our atti-

tude is that while nobody likes to be inspected by their regulator, I truly and firmly believe that Ernst & Young and the entire profession will learn from the process and be better for it.

This is a great profession that I am part of. We are doing everything we can to meet the needs of the capital markets, and we welcome the PCAOB's oversight and support in these efforts.

There are two areas on which we as a profession are very focused, our ability to continue to attract and retain the best people, and our ability to deal with the economic risks we face, and these are serious issues deserving more in-depth consideration than time allows today, but they are topics we are working on both individually as a firm and as a profession, so we can continue to play our unique role in the financial markets in the future.

Thank you again for the opportunity to be here.

Chairman SHELBY. Mr. Bentley.

STATEMENT OF GREG BENTLEY
CEO, BENTLEY SYSTEMS, INC.

Mr. BENTLEY. Good afternoon, Mr. Chairman and Members of the Committee. My name is Greg Bentley. I am the CEO of Bentley Systems, Inc. As a member of the American Business Conference, founded by Arthur Levitt almost 25 years ago, I am honored to represent a growing majority of our economy: Privately held companies and businesses smaller than you hear from most. Significantly, Bentley Systems remains a private company today, despite having filed our preliminary registration statement for an initial public offering in April 2002. We stayed the course in registration despite the seven-figure cost of hiring a second firm to reaudit our financials, replacing Arthur Andersen. In retrospect, the attendant delay turned out to be fortuitous, as it coincided with the promulgation of Sarbanes-Oxley, whereupon we withdrew our offering.

I believe our experiences are relevant to your assessment of policy formulations to stimulate continued entrepreneurship, growth in the private sector, and a robust national economy. To us, this is so critical that in return, I will divulge our "secret sauce" behind our business success to date.

Long before the recent advocacy of an ownership society, Bentley Systems has fruitfully nurtured our ownership culture. Our 20-year-old company has grown profitably, and primarily self-financed, to rank among the larger firms within the global application software industry. In the past decade, we have created over 700 new jobs in the United States, with average annual compensation here now of over $90,000, and our exports contribute over $150 million per year to the U.S. trade balance.

I and my four brothers who founded the company have always recognized that our growth and success is entirely to the credit of our colleagues, who comprise all of the key assets for producing and vending our software. By 2002, the number of colleagues to whom we had granted stock options was approaching the limit of 500—made famous recently by Google—above which, under current law, formal disclosures—and consequently, now, Sarbanes-Oxley adherence—are required. The motivation for our IPO filing was thus less to achieve public ownership per se, but rather to make available deserved liquidity for these longstanding option holders.

At this same time, it happens that I chaired the audit committee of a large public S&P 500 IT services firm. My personal experiences with the various emerging costs and burdens of Sarbanes-Oxley compliance led us to conclude at the time that such costs and distractions would not be prudent for Bentley Systems.

In summary—as I realize you have other witnesses to present the perspective of existing public companies—those costs and burdens are substantial; they are still increasing, and their ultimate extent is still uncertain. Nonetheless, most of us are prepared to accept that in the aggregate, these costs are probably justifiable to preserve confidence for public investors.

But beyond the new compliance costs, what settled Bentley's IPO withdrawal was the mismatch between new corporate governance requirements and our own ownership culture.

It remains especially implausible to me that our founders would relinquish control to a majority of such potential new independent directors as would be willing to expose themselves to the perfect storm of liability risks unleashed by Sarbanes-Oxley, especially for new public companies.

Even if consistent and predictable fundamental performance could be a given, I believe that the volatility in practice of U.S. GAAP accounting standards makes financial restatements more likely than not.

To the extent that convergence with international accounting standards would reinstate principles-based accounting rather than rules-based accounting, every CEO should favor such a change.

In the meantime, occasional downside earning surprises are inevitable, with impact on stock prices. Unfortunately, Sarbanes-Oxley has increased our very real apprehension that hairtrigger plaintiffs' lawyers will misuse the Act's standards to exploit these gotchas as their windfall opportunities.

From a public policy standpoint, in fact, I believe that relatively simple litigation reform could more immediately and effectively redress the excessive risk aversion that Sarbanes-Oxley has engendered than complicated rework of its complex moving parts.

Otherwise, growing and prospering companies like Bentley Systems will tend to remain private indefinitely. Not only will IPO's be less prevalent, but so will acquisitions of private companies by public companies, who would thus incur unaddressed Sarbanes-Oxley liabilities.

Now, are there national interests that may be at risk when a larger segment of our economy consists of larger private companies? Well, there is presently an abundance of equity funds seeking private company investments, fostered by the recent structural tax reforms. Rolling those back, to any extent, would reduce growth funding for our privately led economy, while making them permanent will even more substantially increase the ability of firms like Bentley Systems to invest in faster growth of our exports and our employment.

But financing would be useless without the key ingredient in our Bentley recipe, the ownership culture by which we attract, incent, and reward the colleagues whose intellectual property creation we are all dependent upon. And the good news is I think there can be

some simple public policy changes within the purview of your Committee that could serve even to improve on our original recipe.

My first modest proposal would be to exclude equity grants to employees from the applicable count toward 500 securities holders, since such grants are not the result of any securities purchase decisions.

I would also suggest a policy direction to update the form of ownership culture—which gets beyond the tedious controversy over the options expensing—as a first step in international accounting standards convergence. It would be an unfortunate side effect of the stigma which this negative attention is attracting to options, for companies to significantly reduce the breadth and scope of their option programs without substitute ingredients to sustain their ownership cultures.

Of course, absent the current accounting bias, granting outright shares instead of options would even more completely align employee incentives, to the downside as well as upside with that of the stockholders at large. Unfortunately, the employee would be subject to income tax upon vesting—without a source of liquidity now that Sarbanes-Oxley precludes loans from the employer—in the absence of a public market.

So an evident solution would be to grant the stock into the employee's qualified retirement account, where its value could presumably accumulate tax-advantaged. That would serve to focus companies and employees on long-term, stable career development.

Bentley Systems already makes annual company contributions in stock to our U.S. colleagues' profit-sharing accounts. These are over and above the company's cash matches of colleagues' own 401(k) contributions, so this incentive is always incremental to baseline retirement funding, rather than a substitute. And many other companies take advantage of ESOP plans authorized by Congress to encourage employee ownership.

The problem with either approach, as a candidates to replace broad employee stock option programs, is that ERISA requires such contributions to be nondiscriminatory, essentially proportional to cash compensation for all employees. But in the United States and at Bentley Systems, we have always recognized that our colleagues' efforts and results are not correspondingly distributed equally. The ownership culture cannot generate its potent incentive leverage when it is made into an entitlement.

So, I would finally ask that you consider creating an exception under ERISA for discretionary outright grants of stock to employees for the purposes traditionally served by option grants. This ownership culture secret sauce should be restored and reinforced as a key ingredient in our corporate national economic strategies.

Thanks very much and I look forward to your questions.

Chairman SHELBY. Thank you.

Mr. Moodispaw.

STATEMENT OF LEONARD MOODISPAW PRESIDENT AND CHIEF EXECUTIVE OFFICER ESSEX CORPORATION

Mr. MOODISPAW. Mr. Chairman, Senators, thank, you for the opportunity, and I am certainly mindful that you have my statement

in front of you, so I will just make a few comments. I would like to make them in the perspective of the world I live in.

It is interesting. Much of what Mr. Bentley said, I argue when I talk about the benefits of being a small public company. I will come back to that in a moment. But my perspective starts out with I was a trial lawyer for a long time, and I thought I had graduated when I became a CEO in terms of public respect. I learned very quickly after Enron and WorldCom that that did not happen that way. I do not know where I am going to go next, but whatever profession I go to, watch out, because we are all in trouble.

[Laughter.]

Senator SARBANES. Do not move in this direction.

[Laughter.]

Mr. MOODISPAW. We are a small cap company, and so, people could say, well, wait a minute, now: you are not the subject of 404 yet. We will be subject to 404 next year, and we are very mindful of the impact of 404, so we are already looking very hard at it.

I agree and am pleased with Senator Enzi, who comments on the small business aspects of it. I do believe that the costs are disproportionately high on smaller businesses. The Act takes care of that by talking about management integrity. I worry sometimes, having been a trial lawyer, as to whether I can pass that test, too, but there is that opportunity. It is very subjective, but it is there.

We are also a Government contractor. Most of our work is done with the intelligence and Defense Departments. So we are already subjected to Defense Contract Audit Agency and Defense Logistics Agency Review. So many of the controls and the very basic things that have to be done to satisfy SOX and 404 are already in place for us. What we have learned is, as we look at 404, is that we are becoming more formal—this gets back to Mr. Flint's documentation—but as we look at the processes and procedures, and I will say, we do that, and I will be reminded, it is not written down.

So we are now writing those things down. That is not all bad. We have learned that we are improving efficiency by getting audit committees and more independent people involved earlier on in some acquisition issues and more risk assessment before we go spend money on new technology. That is not all bad, either. The board independence and the ability to bring in the proper data for audit committees and the board is a good thing. I never had the opportunity, but given the opportunity to have a bunch of friendly people sitting around telling me what a great job I am doing that, I would love that.

But that is not going to make the kind of company I want, which is a company with the utmost integrity. So the checks and balances are excellent. The requirement to go off and look for independent accounting expertise has turned out to be a big boon to us, particularly as we do acquisitions. We did two acquisitions of private companies in the last year. Certainly, Sarbanes-Oxley was one of the things we looked at as we examined those companies.

What we looked at was not whether it was good or bad and whether we would buy them or not buy them. Because of SOX, what we looked at was what was going to have to happen, what would we have to do to make them compliant? Some of them are remote: Melbourne, Florida; Texas, and we have one person doing

all the accounting and all the finance. How do we split those things up? Who do they report to? Good questions to ask whether or not we were required to do it. It is like making your children eat their vegetables or take their medicine: you have to do it, and the benefits certainly outweigh the cost. I would rather not have the costs, but they are there, and I do believe we have the benefits.

When I read about and hear about the complaints about Sarbanes-Oxley, I am reminded of an article in *The New York Times* not long ago. I believe it was entitled, "The Dog Ate My Homework," and it listed all the excuses CEO's use when their performance is suffering. And Senator Sarbanes, I would like to commend you on the rapid rise that Sarbanes-Oxley has made on that list, because now, we hear CEO's will somtimes use that as an excuse, although Goldman-Sachs did a survey and said it barely made the screen. But when it is convenient, just like the weather or just like Krispy Kreme blaming a low-carb diet when they have a bad quarter, we will throw out Sarbanes-Oxley, I am sure.

One of the issues that has been discussed, and Mr. Bentley discussed the reverse of this has been will public companies go private? First off, that is very expensive; second, if I tried to do that, I believe those shareholders out there would be wondering what I am trying to hide. I believe the SEC is putting in place some significant requirements so that it would be very difficult to do that. So, I do not think it will save any money. I think it will cost money and would subject me to further scrutiny.

When we look at the reverse, as Mr. Bentley has done, and he mentioned the cost of getting ready for it. When I am on the street, New York, Boston, all of the places I have to go to talk to the investment community, the beautiful people, as I like to call them, I can think of lots of reasons not to be a public company. But none of them are Sarbanes-Oxley, because again, I believe the cost is outweighed by the benefits, and I think the cost of going public leaves those costs insignificant.

As I mentioned, some of what Mr. Bentley said described our company. We are a small public company. We give stock options. It is going to be harder if the rules get passed, but we give stock options to every employee, because we want them to feel like they are a part of the company, and they like it because if they have a good quarter——

Chairman SHELBY. Do you expense those options?

Mr. MOODISPAW. Not now. As I say, we are going to be facing that. We report it——

Chairman SHELBY. Okay.

Mr. MOODISPAW. —but we do not expense them.

But if they have a good quarter, if we have a good quarter, announce that their stock jumps. And this rise that Senator Sarbanes was nice enough to comment on, our shares were $4 a share when we began. They are now at $9 a share. We have a lot of employees who had options at $1 a share. They feel very much a part of the company, and therefore like those, and again, I think being a public company makes them more beneficial.

In closing, I draw an analogy to Y2K. To me, what we are going through with Sarbanes-Oxley is a lot like Y2K. There was a lot of looking for skinny bears behind trees as to what Y2K might bring.

It brought a lot of money—I do not mean E&Y when I say this but auditing companies and consulting companies who went off and advised people about those skinny bears behind trees, and when it happened, a lot of good, important things were accomplished, but it was a nonevent, and we will look back on SOX in that way.

Thank you.

Chairman SHELBY. Thank you.

Thank all of you.

Many contend that the compliance costs and resources associated with implementing the internal control provisions of Section 404 are too burdensome. What type of cost-benefit analysis should the regulators apply as they continue implementation and begin compliance programs?

Mr. Flint.

Mr. FLINT. I think that is a very difficult question, because the cost of failure can only be seen with retrospect. And we all pay insurance hoping we never actually make a claim. I do believe, though, that in a world where we have created a governance framework, where the quality of directors and the independence and the operation of the board is being improved, it is legitimate to give them some element of discretion to allow them to exercise judgment into determining how they execute their responsibilities under 404, because while as I said in my remarks, I think there are a number of areas that we have woken up to that we would be better to formally document how we get to where we get to, there are a great number of areas where we already document things enormously.

We are subject to regulation by 370 regulators, so we have documentation of controls that is extremely detailed, but it was not structured in the way that to the correct interpretation of what is required by the PCAOB guidance to deliver particular accounting attributes. It just was never designed that way nor could it have expected to be. And I think there are many, many elements of our operations where the risk of error is really small, but the cost of documenting in a different way those systems is very high.

I would like to believe that responsibility could be given to directors to make that judgment, because they are accountable, and they can see the penalty for failure. I think they would devote the resource to the areas that they feel more concerned rather than omnibus.

It has to be a judgment. I do not think there is a silver bullet.

Chairman SHELBY. What we are trying to do, I suppose, and the question comes up, is there a way to implement Sarbanes-Oxley that ensures investor protection without creating unnecessary compliance burdens? How do we reach that? Because what is our real goal? Our real goal is integrity in the marketplace, right?

Mr. FLINT. Right.

And indeed, Senator, we accept that fully. And indeed, all of us who signed our certificates in relation to 2003 on Section 302 took the same responsibility and accepted the same accountability as we will take next year; only we will have to show our workings. And it is the degree to which we need to show our workings that I think is unnecessary in part, but I think because of a fear of criticism of

not being omnibus the process has been overengineered in the application of the 404 responsibilities.

I have no difficulty with the 404 responsibilities at all, but I would like to have discretion, I would like to be accountable for how much documentation is required, which was what the PCAOB said as well, but the accounting firms interpretation is different.

Chairman SHELBY. Sure.

Mr. Turley, would you just briefly address how you and your clients are working to implement Section 404, and what should investors and market participants expect from Section 404 reports when they are addressed next year?

Mr. TURLEY. Well, I think both our clients—the issuers—and our firm are working very, very diligently to uphold the law, the Sarbanes-Oxley law, and also the standards as put out by the PCAOB and the SEC. And as others have said, it is a very big effort.

I think the big benefit from 404 is going to come from the transparency and insight that it is going to be provided for investors into the strength of a company's internal controls. I think the costs involved are being felt today while the benefits are largely going to be felt in the future. I think that because it is a new law, it involves new standards, it is a first-time implementation, and I think we do need to do a better job of educating investors as to what it means. What do internal controls really mean? What does it really mean to have management assert to the strength of its internal controls and have an audit firm audit those internal controls?

What does it mean if a company receives a clean opinion on its financial statements but a material weakness or an adverse opinion is provided relative to the companies's internal controls? I think these are all things that are first-time implementation issues that we need to all work on together. The PCAOB, the SEC, issuers, all of us, need to make sure we educate people on that.

Chairman SHELBY. Mr. Bentley and Mr. Moodispaw, what impact has Sarbanes-Oxley had on capital formation, in other words, keeping companies from going public, staying private and so forth?

Mr. BENTLEY. Well, the apprehension about going public, just to pick up on——

Chairman SHELBY. You mentioned that earlier.

Mr. BENTLEY. Yes, is less so; frankly, the cost of compliance than it is what is unknown—and, in particular, as to liability. Although I think Sarbanes-Oxley was a very effective and timely piece of legislation that deserves a chance to work, my concern as a prospective issuer is that there would be inadvertent aspects of noncompliance or something that goes wrong the first time through, that is not material, that is going to be seized upon to create a liability.

Chairman SHELBY. Unintended consequences?

Mr. BENTLEY. Yes, that is the concern.

Chairman SHELBY. Mr. Moodispaw.

Mr. MOODISPAW. We did a capital raise last year, a secondary offering; we were already public, but we went on the road. And the travel alone should deter anybody from doing that, much less the SOX requirements, but we raised $32 million last year from a lot of large funds around the country.

There was very little discussion of Sarbanes-Oxley amongst the institutions as we went around. My concern is that it almost be-

comes a checklist kind of thing: they will ask the question, are you compliant? If you are compliant, they move on. But it did not inhibit us at all.

Chairman SHELBY. Mr. Flint, has there been an impact? Has Sarbanes-Oxley created an impact on the capital raising decisions of international companies, in other words, to list or not list?

Mr. FLINT. I think it is too soon to say. I think that people are pausing for thought as to whether to list in the United States. I mean, we would still list today in the United States. The benefits are important. I think what has changed, though, in the last 5 years, really, as a result of the introduction of the euro is that the U.S. capital markets used to be necessary for the raising of both equity and debt capital. Today, it is really only necessary to have a listing if one intends to make an acquisition in the United States. The European markets can raise debt in size as deep as the U.S. markets now.

So, I think it has made some companies question the cost-benefit of a U.S. listing, yes, and indeed, you have had very few foreign registrants in the last year.

Chairman SHELBY. I know.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, because I think it is an important point, I want to follow up, Mr. Chairman, on something that Mr. Turley said, and then, you touched on it in your questions. I think it is important to develop an understanding so that a report that cites an internal control weakness is not then transposed into a financial statement inaccuracy, as Mr. Turley has underscored in his statement, both written and oral here today.

And as I understand it, you are engaged now in a process, I take it you and the other major accounting firms, with both the SEC and the PCAOB to try to work out a way in which you can educate and inform on that particular issue. Is that correct?

Mr. TURLEY. Yes, we are. We are working with the PCAOB, working with the SEC, working with FEI, and others. We would like to work with everybody, because I do think that it is important that investors understand the differences between the opinion that they read on the financial statements themselves and the accuracy thereof and the strength or weaknesses within a system of internal controls. I think it is very important that people understand that we and others are working hard on helping that.

Senator SARBANES. Yes, well, you can have a weakness in your internal controls, have an absolutely accurate financial statement, or conversely, have no weakness in your internal controls and have an inaccurate financial statement; is that not the case?

Mr. TURLEY. Well, the converse would be harder than the former.

Senator SARBANES. You hope. You would certainly hope so.

Mr. TURLEY. In some ways, the audit of the financial statements is basically a question of, is the financial statement put in front of you free of material error after the external audit?

Senator SARBANES. Right.

Mr. TURLEY. The audit of internal controls is really a question of could there have been an error in the financial statements management put together before the external audit? So if an external

audit identified a material error in a set of financial statements, and that error was then corrected by management in its accounts before they were published, the financial statements would get a clean opinion; I think it is likely that the internal controls would have been weak in that case.

Senator SARBANES. Yes; Mr. Hanish, in *The Wall Street Journal* on June 21, you were quoted as saying Sarbanes-Oxley, "triggered a comprehensive review of how Eli Lilly documents corporate controls, and the discipline of that has been tremendous. The review uncovered some redundancies, allowing the firm to eliminate some steps it was taking needlessly. We added some controls as well. In all, it was time and money well-spent." Is that still your view?

Mr. HANISH. Absolutely, absolutely.

Senator SARBANES. All right.

Mr. HANISH. I think that overall, as I indicated both in my remarks for FEI but also my own personal view is that the impact of Sarbanes-Oxley is still very positive. The impact that it has had on documentation has been quite positive. I think our ability to potentially identify redundancies, reduce certain activities, streamline operations, we view that as a positive, and we will be spending a lot more time in 2005 as we get beyond this initial mountain that we are trying to climb right now, to be able to spend more time reviewing the flow charts and the various pieces of documentation that we have.

I think the challenge, however, is in identifying various gaps, there is a lot of focus on form over substance, and documenting the fact that something took place as opposed to looking at what truly occurred, I think, has been a significant focus on the part of the auditors during this period of time.

Senator SARBANES. Well, it is a new system that is being put in place, and the precedents have not fully been established, and I presume through an interaction between the auditors, the PCAOB, and the SEC, it will get to a state of reasonableness. In fact, I have seen some of these handbooks that have been prepared, either by the accounting firms or the lawyers, saying to a company what is required by Sarbanes-Oxley, and I have looked at some of that, and I have said, now, wait a second: Where in the Act is that required?

So they are going to great lengths, and in many instances, beyond what is required. In fact, Mr. Bentley, I wanted to ask you on that point, you state that you decided to remain private because your company did not want to have a majority of independent directors. Now, where in Sarbanes-Oxley is there a requirement that a public company have a majority of independent directors? On their audit committee, but where in the Act do we require that a public company have a majority of independent directors?

It is true that the exchanges and best practices now are instituting that requirement of a majority of independent directors, but I do not think that requirement is in the Act.

Mr. BENTLEY. No, that was part of the exchanges' fulfillment of their obligation under the Act to update their listing requirements.

Senator SARBANES. No, no, the Act required the SEC to make sure the exchanges had certain listing requirements that went essentially to the role of the audit committee, both its composition, its hiring and firing of the auditors, its being appropriately funded

and so forth. But there is nothing in the act requiring independent directors. Now, it is true that that is now becoming a requirement. The exchanges are making it a listing requirement, and all of these private best practices seminars now within the business community are reaching that conclusion.

But I put that question to you just make the point that we are addressing here. In other words, it is not the Act that requires that, is it?

Mr. BENTLEY. Well, to update the facts as I understand them, the first drafts of the exchange listing requirements from both the New York Stock Exchange—where we were listing—and Nasdaq required an outright independent majority on the board for the first time.

Senator SARBANES. Well, I am not questioning that. I am only questioning your assertion that that was required by the Act. I do not think that is the case.

Mr. BENTLEY. I think the Act only required them to issue new standards. Those were the standards they issued. And that had not been the case when we filed, so we were faced with a situation of it being impossible to comply, because we did not have the independent directors and did not feel that we could recruit them under the atmosphere of uncertainty at the time.

Since we are trying to be fastidious about the facts here: The exchanges amended their listing requirements to permit there to be an exception to the majority independent board requirement for a so-called "controlled entity."

Now, Google, which I think could have resorted to that exception, did not, although I congratulate them on their successful IPO. Of course, there is only one Google, and you cannot extrapolate from that to other companies. But they saw the virtue of selling to their investors that there are founders who have a track record, and you can confidently invest in those who do control the company.

So, I think there has turned out, just as you are suggesting, to be some accommodation in the world to what looked like outright dogmatic extremes to start with. We are coping.

Senator SARBANES. Well, I want to be very clear on this, because it does point out a problem. People come to us, and they complain about something or other, and then, when you investigate it, it turns out that what they are complaining about is not a consequence of the Act. It is some other action that has been taken by one or another of the regulatory authorities or some best practices that have been adopted by the industry.

All the Act required was for the SEC to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraphs 2 through 6, which all deal with the audit committee, not with the board of directors. So the Act has no requirement that the board of directors be independent, although it is true that the exchanges put that in as a listing requirement, but that was a separate decision from the Act.

Now, as you point out, the exchanges have since come back and made an accommodation on that listing requirement. I just do not want to have to carry more of a burden than is necessary.

[Laughter.]

Now, Mr. Hanish, I want to ask you about this survey. I am very interested in these surveys you cited.

Mr. HANISH. Yes.

Senator SARBANES. The FEI survey about the increase in costs between January and June. Were exactly the same companies used in the January survey and the June survey? Well, let me put the question to you. I am not really trying to trap you here.

Mr. HANISH. Okay.

Senator SARBANES. It is my understanding that the same companies were not used entirely and that the shift that took place was that more large companies were included in the June survey than had been included in the January survey. Therefore, their costs for doing the 404 would be higher, and therefore, that explains the difference between the survey findings, at least in part, if not in whole; I do not know the answer to that question, but it would explain in part the increase in costs which you cited.

In effect, we did not have a comparison of apples-to-apples. It differed somewhat, and it differed in the direction of including in the second sample larger companies who would have had larger costs to do the 404 certification. Am I correct in that understanding?

Mr. HANISH. Essentially, the survey in July had more larger companies.

Senator SARBANES. Right.

Mr. HANISH. Companies that had revenues in excess of $5 billion than the January survey.

Senator SARBANES. Right.

Mr. HANISH. It was certainly not an identical composite of companies.

Senator SARBANES. In fact, I understand that the survey found the total 404 costs actually fell for the smallest companies, those with revenues less than $100 million, between January and July.

Mr. HANISH. I am not sure about that point, but you may be right, but I am not sure about that point. But I do know that, for example, we would not have participated in the January survey, because we had not resolved all of our costs with our external auditors. So it was inappropriate, for example, for Eli Lilly to participate fully in the January survey as opposed to the July survey, where by that time, we had resolved our fee negotiations with our external auditors.

So we would not have been in a position at that point in time to respond to the January survey. I think that was part of the issue with January. A lot of the large companies had not, like ours, at that point in time, had the opportunity to resolve all of their fee discussions with us.

Senator SARBANES. No, I understand that. My only problem is if you are comparing two surveys and saying the costs have risen, but you are including in the later survey which supposedly demonstrates the increase in cost more larger companies than were included in the earlier survey who are going to have larger costs, then obviously, the costs are going to go up. It does not establish, I think, the point that was asserted.

Mr. HANISH. I think the point that I was trying to make in the remarks was not so much that the costs had gone up because of additional activities in that period of time but because of more com-

panies being surveyed, more and better information available to us that the costs, the average costs to comply have certainly increased over what the January survey would suggest that the costs would have been on average, because now, we have better data or data from some larger companies as well to throw into the mix.

Senator SARBANES. Finally, Mr. Chairman, I know I have run over my time. I would like to have included in the record a *Wall Street Journal* editorial, July 30, 2004, by Bob Greifeld, the president and CEO of Nasdaq, entitled, "The View from Nasdaq," and I would just mention a couple of points that Greifeld makes in the——

Chairman SHELBY. That will be included in the record without objection

Senator SARBANES. First, he writes with respect to Section 404, "I believe that even beyond the improvement in public confidence, the vast majority of businesses will benefit from going through the process of establishing, maintaining and reviewing the internal control structure that Section 404 requires. While every nickel counts, complying with Sarbanes-Oxley, in my view, is money well spent. I can affirm that it has not hindered our ability to innovate."

And then, he goes on to say,"A concern raised by critics is that Sarbanes-Oxley deters private companies from going public. I am sure there are some isolated cases, but on the whole, the claim is nonsense. There are 150 companies in the pipeline who have filed to list their IPO's with us. Year-to-date, more than 92 companies have gone public on Nasdaq compared with just 10 in the same period in 2003. The executives of these companies understand they will be governed by Sarbanes-Oxley."

And he then goes on to say, "So far this year, 10 companies from abroad have listed on the Nasdaq. The faith and integrity of the U.S. markets is one reason. We want more foreign listings. Sarbanes-Oxley will help." Those are just certain excerpts from the article.

Chairman SHELBY. Sure.

Senator SARBANES. Thank you very much.

Chairman SHELBY. Thank you.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman, and I thank the panel for all of the excellent testimony that they gave. I just have a couple of questions. Mr. Turley, in your testimony, you mentioned the upcoming Section 404 reports that will be coming due for the large corporations in February of 2005. Does the PCAOB auditing standards provide for different treatment or approaches for auditors based on the size of the company? Are small businesses treated any differently under the standards?

Mr. TURLEY. Well, no, Senator, the standards really are written as applying one standard to all-sized companies, and I think that as I talk to companies around the country, large and small this issue we have been talking about today on the costs versus the benefit does come up. Companies large and small that—in my judgment—look at applying 404 as all cost, no benefit, get just that: They get all cost, no benefit. Those that look at it as a way to improve processes get improvements.

Senator ENZI. Well, to the extent that the PCAOB wanted to facilitate flexibility based on concerns that might apply to small public companies or specific industries, would it be helpful or even necessary for additional guidance to be issued by PCAOB? Otherwise, it would seem the auditor would be placed in a difficult position if you were asked for flexibility without written direction. Would that be the case?

Mr. TURLEY. Senator, I think what you are asking is a complex issue. Because investors in small companies are, I think, looking for really the same things that investors in large companies are looking for as it relates to when they see a set of financial statements and have, if you will, the same opinions written on the financials and the same opinions written on the 404 requirements, they would have the same expectations, whether there are three more zeroes on the end of the big company or not.

I think that historically, our profession has shied away from encouraging different standards, if you will, based on whether it is large cap or small cap. I think that to the extent that PCAOB would like to entertain differences or the SEC would like to entertain differences for small companies, I think it would be necessary for guidance to come out.

Senator ENZI. Okay, thank you.

Mr. Bentley, I also serve on the Health, Education, Labor and Pensions Committee, and I want to thank you for your specific suggestions in your testimony that deal with retirement in particular, and it gives us a third approach to some sticky problems. So, I appreciate it.

Thank you, Mr. Chairman.

Chairman SHELBY. I want to thank all of you. We have got another vote on the floor, as I knew we would, on Homeland Security appropriations. I want to thank everybody for, one, your patience sitting through the first panel. I thought it was a good panel and for also your contribution here today. And a lot of you have come from way off, and we will continue to do oversight on all legislation, including Sarbanes-Oxley. I think we learned from hearing from you. Thank you very much.

The hearing is adjourned.

[Whereupon, at 5:14 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF ANDREW SHENG

CHAIRMAN, SECURITIES AND FUTURES COMMISSION HONG KONG SAR

SEPTEMBER 9, 2004

Good afternoon, Chairman Shelby and distinguished Members of the Senate Committee.

Thank you for inviting me to testify about the international impact of the Sarbanes-Oxley Act and developments concerning convergence of international securities laws.

A Brief Background About the Hong Kong Securities Market

First, I must give the disclaimer that the views I express here are my personal views and do not reflect the views of the Hong Kong Securities and Futures Commission, the individual members of the Commission nor its staff, nor of the International Organization of Securities Commissions (IOSCO), where I currently serve as Chairman of its Technical Committee, nor any of its member jurisdictions.

Hong Kong is the largest stock market in Asia outside Japan and is the eighth largest market in the world in terms of market capitalization. There are a total of 1,074 companies listed on the Hong Kong Stock Exchange with a total capitalization of $713.9 billion as at the end of July 2004 and market turnover of $486 billion for the 12 months ending July 2004.

Hong Kong is the leading international financial centre in its time zone, with 80 of the top 100 global banks having offices in Hong Kong, as well as most of the major U.S. investment banks and securities houses. Hong Kong has the largest concentration of international accountants and legal offices in Asia outside Japan. As at the end of 2003, the equity securities of 21 companies were traded concurrently on the Hong Kong Stock Exchange and New York stock exchanges (19 companies on the New York Stock Exchange and 2 on Nasdaq). A major feature of the Hong Kong market is that roughly 80 percent of Hong Kong listed companies are incorporated outside Hong Kong, primarily in Bermuda, the Cayman Islands, and the mainland of the People's Republic of China.

Another feature of the Hong Kong market is that unlike many other Asian markets which are retail dominated, local and overseas institutional investors account for 28 percent and 39 percent respectively, of the total market turnover during the period 2002–2003.[1] Overseas investors, principally institutional investors, have increasingly become dominant players in the Hong Kong stock market. U.S. investors are active in the Hong Kong market and, likewise, Hong Kong investors are familiar with U.S. and other international markets.

Hong Kong Regulation of Issuers

All issuers whose securities are listed for trading on the Hong Kong Stock Exchange must comply with the Securities and Futures Ordinance and other Hong Kong securities regulations, such as the nonstatutory Listing Rules[2] and the Takeovers Code,[3] irrespective of their place of incorporation.

For historical reasons, our Listing Rules are based on the Listing Rules of the United Kingdom. The Hong Kong Stock Exchange is currently finalising a new corporate governance code for listed issuers called the Code on Corporate Governance Practices, which is benchmarked against the U.K. corporate governance code, known as the "Combined Code." The Hong Kong Code operates on a comply-or-explain principle.

Since the Securities and Futures Ordinance came into operation in April 2003, all initial public offerings of securities in Hong Kong are filed with both the Hong Kong Stock Exchange and the Securities and Futures Commission (the HKSFC), thus strengthening the enforcement of disclosure requirements by issuers. The Hong Kong Stock Exchange is responsible for enforcing its Listing Rules, and the HKSFC is responsible for enforcing corporate disclosure requirements pursuant to the Securities and Futures Ordinance. It is a criminal offence under the Securities and Futures Ordinance to provide the HKSFC with false or misleading statements in a corporate disclosure filing.

The Hong Kong Government has also agreed to amend the law to give statutory effect to the more important listing requirements in the Listing Rules. Once these

[1] Understanding Investors in the Hong Kong Listed Securities and Derivatives Markets, Essie Tsoi, Research & Planning Department, Hong Kong Exchanges and Clearing Limited (July 2004). Available on the SFC website at *http://www.hksfc.org.hk/eng/statistics/html/index/index0.html.*

[2] The Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Ltd.

[3] Codes on Takeovers and Mergers and Share Repurchases (Takeovers Code).

statutory listing rules come into force, listed issuers, their directors, and corporate officers will each be criminally and civilly liable for compliance with the specific disclosure obligations set out in the rules. These rules, too, will not distinguish between domestic and foreign issuers.

The Hong Kong accounting and auditing standards essentially follow the International Financial Reporting Standards and the International Standards on Auditing. The Hong Kong accounting standards reflect 95 percent of the current International Financial Reporting Standards and are on course to be fully compliant with International Financial Reporting Standards.

Similarly, the Hong Kong auditing standards-setting body is in the final stages of completing an exercise to make some minor amendments to current Hong Kong auditing standards to bring them into full compliance with International Standards on Auditing by January 2005.

The Hong Kong and United States Market

There are considerable United States and Hong Kong cross-border securities and capital transactions. The HKSFC has always valued its long and productive relationship with the U.S. Securities and Exchange Commission (the U.S. SEC) and the Commodity Futures Trading Commission (CFTC). In October 1995, the HKSFC entered into Memoranda of Understanding with the U.S. SEC and the CFTC, respectively, to enhance our mutual cooperation in the administration and enforcement of securities laws in our respective jurisdictions.

The HKSFC is also a signatory to the IOSCO Multilateral Memorandum of Understanding[4] (IOSCO MMOU), the first global information-sharing and enforcement cooperation arrangement among securities regulators introduced in 2002. The IOSCO MMOU sets a new international benchmark for cooperation among securities regulators in order to enhance enforcement of securities laws internationally. Through the IOSCO MMOU, the world's securities regulators have set the broad terms of cooperation and assistance a securities regulator must offer to its fellow securities regulators in order to be considered a responsible member of the international regulatory community.

The globalization of international financial markets has also precipitated an increasing convergence between the Hong Kong and United States models of securities regulation. In my view, the Hong Kong Government's decision to give statutory effect to the more important provisions of our Listing Rules moves Hong Kong closer to the U.S. SEC regulatory model.

Impact of the Sarbanes-Oxley Act on Hong Kong

U.S. based firms, and companies whose securities are traded both in Hong Kong and the United States , are already familiar with the Sarbanes-Oxley Act and are required to comply with its requirements. My personal view of Sarbanes-Oxley is that it was a quick and effective response to potential an erosion of confidence in U.S. capital markets resulting from high profile accounting frauds and corporate governance failures at issuers such as Enron and WorldCom. Sarbanes-Oxley heightened awareness around the world of the scope of directors' fiduciary responsibilities. It has also raised awareness of the need for enhanced corporate governance and auditor independence, the need to improve oversight of the accounting and audit professions, as well as the need to strengthen the protection of investors' interests. Market participants tell me that preparation to comply with the certification and internal control review requirements under Sarbanes-Oxley often identified control weaknesses. These are areas clearly where Sarbanes-Oxley made a difference.

On the other hand, there is industry concern over the rising costs of compliance with Sarbanes-Oxley's increased regulatory requirements, not only in monetary terms, but also in terms of manpower and IT development. Some feel that the requirements are restrictive and excessively onerous in nature, compared to corporations that do not have to comply with Sarbanes-Oxley.

However, it must be pointed out that Hong Kong rules and regulations do not conflict with Sarbanes-Oxley requirements. Our regulatory regime covers most, but not all, of the main areas addressed in Sarbanes-Oxley, albeit in much less detail and with less prescription. For example:

Audit Committees

Our Listing Rules require companies whose securities are listed in Hong Kong to set up audit committees composed of a majority of independent nonexecutive direc-

[4] IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2002).

tors, one of whom must have appropriate accounting or related financial qualifications or expertise.

The Code on Corporate Governance Practices that will be incorporated into the Listing Rules will recommend that a listed issuer's audit committee review and monitor the independence and objectivity of their external auditors and the effectiveness of the audit process. The Code will further recommend that the audit committee's terms of reference include a responsibility to advise the board of directors on the appointment and removal of the external auditors and to approve the remuneration and terms of engagement of the external auditor.

Responsibility for Financial Statements

Directors have a legal obligation to prepare statements of accounts that give a true and fair view of the company's financial position at the end of its financial year. Failure to do so is a criminal offence under the Companies Ordinance.[5] Although the company's statement of accounts is signed by two of the directors, the board of directors has collective responsibility for the company's accounts as it must be approved by the board of directors.[6] This contrasts with the Sarbanes-Oxley obligations that require the chief executive officer and the chief financial officer to certify, amongst others, that the financial statements and other financial information in the company's financial report fairly present in all material respects the financial condition and results of the company as of, and for the periods presented in the report.

Once the statutory listing rules come into force, listed issuers, their directors and corporate officers will each be criminally and civilly liable for false and misleading financial statements published by an issuer.

Prohibition of Loans to Directors

Hong Kong company law prohibits loans to directors. There are certain exceptions to the general prohibition, particularly for banks, which are allowed to lend money or provide guarantees or any security to their directors, provided the terms of the financial assistance given are no more favorable than those given to third parties.[7]

Convergence of Securities Regulations

Contradictory or duplicative regulations in different jurisdictions covering similar regulated activities in various capital markets place a heavy burden on issuers, market participants, and investors active on a cross-border basis in those markets. With the advent of globalization, conflicting regulatory requirements of different jurisdictions can impede cross-border capital flows or create barriers to entry to the provision of services on a cross-border basis by a financial services firm. With respect to the regulation of cross-border transactions and services in the international capital markets, each national securities regulator has had to assess its regulatory requirements, within the context of its domestic law, to try to strike an appropriate regulatory balance. On one hand, regulators do not want to impose or maintain regulations that increase costs to market participants without enhancing investor protection. On the other hand, the role of regulators is to protect investors and maintain investor confidence through the imposition of appropriate regulations, notwithstanding the resulting costs to market participants. Maintaining market confidence is paramount, and regulators internationally agree on the need to facilitate cross-border capital formation without jeopardizing investors' interests.

To achieve this, securities regulators around the world must take a global view of regulation and work together. There must be international convergence of securities regulation. In my view, such a convergence of regulations applicable to capital markets internationally would be beneficial to all who participate in those markets. For example, it would facilitate individual jurisdictions' move toward a common goal of implementing effective securities regulations locally; thereby minimizing costs to market participants whilst maintaining uniformly high levels of investor protection and confidence in capital markets.

Please note that I use the term "convergence of securities regulation" rather than the term "harmonization of securities regulation." I do this intentionally because, as I see it, "harmonization of securities regulation" implies that each jurisdiction would have identical or nearly identical rules and regulations. This is not a realistic goal as securities regulations must fit each jurisdiction's legal and regulatory environment and reflect the realities of their different market structures. As these differ significantly internationally, a full harmonization of securities rules and regulations is not strictly feasible.

[5] Section 123 of the Companies Ordinance (Chapter 32).
[6] Section 129B of the Companies Ordinance (Chapter 32).
[7] Section 157B of the Companies Ordinance (Chapter 32).

"Convergence," on the other hand, occurs when two or more sets of regulations gravitate toward one another to achieve almost identical regulatory principles or objectives. Convergence of regulation recognizes that while there are certain international regulatory principles and objectives that each jurisdiction strives to reach, different rules and regulations can achieve the same basic regulatory goals, such as the frequency of auditor rotation, and the composition and duties of the audit committees. However, I feel strongly that international securities regulations must converge at international best practices; in "a race toward quality" rather than "a race to the lowest common denominator."

Why Is Convergence of Regulatory Standards Important?

With international convergence of regulation, investors could be confident that their interaction with foreign market participants and issuers are subject to the same regulatory requirements as those in the domestic market, allowing foreign and domestic issuers and market participants to compete on a level playing field.

As an added benefit, convergence of regulation will reduce compliance burdens and encourage multiple market access. Market forces rather than regulatory costs would become the determining factor for issuers and investors alike in choosing the markets they wish to participate in and the extent of such participation. International convergence of regulation will lower transaction costs for issuers and market participants who are currently dealing with the varying regulatory requirements of all jurisdictions in which they operate while promoting the highest standards of investor protection. As market forces would be the driver for the selection of markets, jurisdictions around the globe would strive to enhance their regulatory model and market infrastructure. At the same time, investors would enjoy greater protection of their interests.

The work by the U.S. Financial Accounting Standards Board and the International Accounting Standards Board to converge the U.S. GAAP with the International Financial Reporting Standards is probably one of the most important, if not the most ambitious, convergence exercises to date. True convergence of the U.S. GAAP and International Financial Reporting Standards would eliminate the need to reconcile statements of accounts prepared in accordance with one set of standards with results that would pertain using the other set of standards. Upward convergence would enhance investor protection in all jurisdictions that adopt International Financial Reporting Standards, as investors will be able to easily compare the financial statements in all of these markets. The progress toward market integration and the reduction in the regulatory burden of multiple market access will largely depend on the success of this effort. I personally agree with and support such convergence of international accounting standards and commend both standard-setters on their work.

One of the much debated topics where accounting standard-setters are seeking to adopt common principles worldwide is the issue of expensing stock options. I support the proposals to expense stock options. I believe that financial statements should reflect the true position of all transactions. Granting employees stock options is a form of compensation; it gives employees a benefit and is an expense to the company. In putting the case for this treatment, I cannot improve on the sage words of Warren Buffet: "If options aren't a form of compensation, what are they? If compensation is not an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

How do Regulators Achieve Convergence of Their Regulatory Standards?

The international regulatory community must work together to avoid conflict in regulatory approaches and facilitate cross-border business while maintaining high regulatory standards. This can be achieved through dialogue, be it bilateral dialogue between two regulatory agencies or multilateral dialogue through international organizations, such as IOSCO. Both SEC and CFTC are prominent members of IOSCO.

IOSCO provides an effective forum where securities regulators can exchange views and explore new ideas and approaches to strengthen cross-border securities regulation and cooperation in a coherent manner that closes gaps in regulation, while avoiding duplication or conflicts in regulation. For instance, Hong Kong participates in an IOSCO Chairmen's Task Force that is developing a Code of Conduct for Credit Rating Agencies. This Code of Conduct seeks to address many of the concerns raised by the industry, and the role credit rating agencies play in modern financial markets. The proposed Code will follow the general structure of an IOSCO Statement of Principles Regarding Activities of Credit Rating Agencies adopted in October 2003 and would serve as a model code of conduct for credit rating agencies all over the world.

Since its establishment 21 years ago, IOSCO has undertaken numerous projects designed to improve the regulation of securities markets and the level of cooperation among its members, including issuing regulatory standards and principles. These standards and principles are not legally binding and do not prescribe a certain type of regulation or any particular regulatory structure; rather, they reflect a consensus among securities regulators on regulatory objectives in each of these areas. Each IOSCO member jurisdiction may then devise the means most appropriate to its own structure and circumstances by which to implement the IOSCO principles. Through IOSCO, the member countries work together to develop the highest standards of regulation. For instance, the IOSCO principles governing oversight of auditors[8] and auditor independence[9] have become the international standards for the regulation of auditors. These IOSCO principles have become the principal framework for securities regulation in many countries.

Is Convergence of Regulatory Standards Enough?

However, merely converging regulation to meet international standards and principles is not sufficient; as disparities in the implementation of these regulations can nullify the benefits of convergence. It is essential that there is some degree of consistent interpretation, application and enforcement of these regulations to create a level playing field for a truly global market. IOSCO has a key role to play in this regard and increasingly it is focusing its attention on facilitating the implementation of its standards and principles among its member jurisdictions.

The HKSFC has a long history of cooperating extensively with other regulatory and law enforcement agencies, including the SEC and CFTC. We have entered into 33 cooperation arrangements with our counterparts in other jurisdictions to exchange confidential information or to facilitate cross-border investigation and enforcement actions. The HKSFC is also one of 26 signatories so far to the IOSCO MMOU. Through IOSCO, and more particularly the IOSCO MMOU, we have sought to promote cooperation and information sharing among the international securities regulatory community, especially in the area of investigating and prosecuting violations of securities laws and regulations. The IOSCO MMOU does not create legally binding obligations on its signatories nor does it supersede domestic laws. Nonetheless, it has encouraged a number of jurisdictions to enact laws to permit their securities regulators to share information and cooperate with their foreign counterparts in accordance with the international benchmark articulated in the IOSCO MMOU.

Conclusion

Let me conclude by saying that in light of today's globalized markets, regulators face a multitude of challenges. Not only are the issues complex, with financial innovation and market developments raising new issues daily, but also investor expectations are at an all-time high. The recent high-profile global financial and securities fraud scandals have rocked the world's financial markets and underscored the need for high standards and cross-border cooperation. Tremendous strides have been made in many areas in seeking global approaches to securities regulation. Regulators must continue to work together, through international organizations such as IOSCO, to establish the high regulatory standards that the world's investors rightly expect and to cooperate on cross-border enforcement actions. International convergence of regulation and strengthened cooperation in enforcement of these regulations together offer the best way to create a truly global regulatory framework for the global securities market.

Thank you for your attention.

PREPARED STATEMENT OF PAUL BOYLE

CHIEF EXECUTIVE, FINANCIAL REPORTING COUNCIL (U.K.)

SEPTEMBER 9, 2004

Mr. Chairman and Members of the Committee, it is my privilege to appear here today as the first Chief Executive of the United Kingdom's new Financial Reporting Council (FRC), a position which I took up a few months ago. The aim of the FRC is to promote confidence in corporate reporting and governance in the United Kingdom. We believe in wealth creation. We believe that our role in promoting con-

[8] Principles for Auditor Oversight (October 2002).

[9] Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence (October 2002)

fidence in corporate reporting and governance can make the creation of wealth more likely.

I hope that our mission means that we are in a position to assist the Committee in its review of the impact of the Sarbanes-Oxley Act and developments concerning international convergence.

In my remarks this afternoon, I wanted to focus on three matters, which I think will be particularly relevant to the Committee's review:

- the new regulatory regime for accounting and audit in the United Kingdom, under the control of the FRC, which was designed following the Enron and WorldCom cases;
- the FRC's stance on international convergence of accounting and auditing regulation; and
- the United Kingdom's approach to promoting high standards of internal control in public listed companies.

The New Regulatory Regime in the United Kingdom

It is an indication of the increasingly global nature of the capital markets that the corporate scandals (including Enron and WorldCom and the related collapse of Andersen) which shocked U.S. investors have also had a significant impact on the U.K. market, notwithstanding the fact that there have been no cases of comparable significance in the United Kingdom for some years.

In fact, the United Kingdom had experienced cases of similar impact a little over a decade earlier, in the late 1980's. At that time there were a number of examples of large and apparently profitable companies which suddenly collapsed into bankruptcy. These cases had prompted the U.K. Government to commission a review of the arrangements for the setting and enforcement of accounting standards in the United Kingdom.

This review led in 1990 to the removal of the responsibility for setting accounting standards from the accountancy profession and the establishment of an independent standard-setting body (the Accounting Standards Board (ASB), whose first Chairman was David Tweedie). In addition, a new body, the Financial Reporting Review Panel (FRRP) was established to review cases of alleged failure to comply with accounting standards and to ensure that financial statements which did not comply with those standards were corrected. The ASB and the FRRP were established as subsidiaries of a new organisation, the FRC, which was responsible for raising the funding for these new activities and for ensuring their independence. The FRC's Council was composed of a broad selection of representatives from the business community in the United Kingdom, including public companies, investors and the accountancy profession.

The new arrangements worked well during the 1990's. The ASB, led by Sir David, embarked on a major programme of reform of accounting standards in the United Kingdom. The main accounting abuses which had contributed to the corporate scandals of the 1980's were tackled. The new standards dealt with complex and politically sensitive topics including off-balance sheet finance, pensions, acquisitions, and so-called "big bath" provisions. During this period the ASB demonstrated its ability to influence financial reporting internationally by working with the International Accounting Standards Committee, FASB and other national standard-setters. The FRRP established its credibility by taking a firm stand in requiring a number of companies to restate their financial statements or to undertake to amend their accounting practices in future. The true impact of the FRRP far exceeded the number of cases which it actually dealt with because once its credibility was established auditors used the unpleasantness of an FRRP investigation as a mechanism to persuade some clients to improve their accounting practices.

There were two other themes in corporate reporting and governance during the 1990's which are important to an understanding of the development of the regulatory regime in the United Kingdom.

The first theme was the progressive move away from entirely self-regulation of auditing by the accountancy profession toward independent regulation in a statutory framework. The initial moves were made in the early 1990's with a significant tightening of the long-standing restrictions on who could perform audits in the United Kingdom to those who were members of certain professional bodies. A statutory requirement was introduced for the professional bodies to be recognised by the Government against detailed requirements as to their audit qualifications and the rules and practices governing the conduct of their members. A requirement for registration of auditors was introduced. The effect of these changes was that the accountancy profession retained the primary responsibility for regulation of auditors but it was required to do so within a statutory framework and it was subject to oversight

by the Government. In the early 1990's the accountancy profession also agreed that 50 percent of the members of the audit standard-setting body should be nonauditors, which was a significant development at that time.

In the late 1990's the Government became increasingly persuaded that public expectations required greater independent oversight of the regulation of the profession. The Government agreed with the main professional bodies in the United Kingdom that certain key regulatory activities, including the setting of auditing standards and ethical standards, would be transferred to an independent but nonstatutory regulator, the Accountancy Foundation, which was to be entirely funded by the profession. The Foundation commenced operations in 2000.

The second theme was the emergence of a consensus about the importance of corporate governance. This consensus (which is considerably stronger now than it was when the subject was first aired) has been built up around a series of reviews, starting with the Cadbury Report which was published in 1992 and which was extended by two further reviews later in the decade. These further reviews led to a consolidation of the various recommendations in a document known as the Combined Code on Corporate Governance.

The key propositions in the Combined Code are that it is important to avoid an undue concentration of power at the top of a company, that Boards of Directors should have a strong group of nonexecutive directors who are considered to be independent, that Boards need to be properly organised to ensure that companies are run for the benefit of their shareholders rather than for the management and that there should be full disclosure of directors' remuneration. A distinctive feature of the Combined Code is that it recognises that recommendations on best practice in corporate governance may not be appropriate in all circumstances. The Code, therefore, operates on a "comply-or-explain" basis which means that public listed companies are expected to follow the provisions of the Code in full or to explain in what respects they have departed from it.

One specific recommendation of the 1992 Cadbury Report which may be of particular relevance to the Committee relates to internal control. I will return to this topic in the third section of my remarks.

The 1990's was, therefore, a decade in which there had been considerable change in the regulatory regime for financial reporting, auditing, and corporate governance in the United Kingdom. By the end of the decade the U.K. arrangements were in many respects more developed than those in other major financial markets.

This was the position in the United Kingdom when the major corporate scandals in the United States and the collapse of Andersen occurred. Although it had been some years since there had been scandals of equivalent significance in the United Kingdom, the Government decided that it would be prudent to consider whether further strengthening of the regime in the United Kingdom would be appropriate. During 2002 the Government commissioned four reports on different aspects of the regime and the results of these reviews were announced in January 2003. One direct result of these reviews was a significant widening and deepening of the role of the FRC, including taking over the functions of the Accountancy Foundation with effect from 1 April 2004. It is, however, a feature of the new regime in the United Kingdom that the accountancy profession is still expected to contribute to the regulation of its members.

The FRC is now a unified, independent regulator which:

- sets, monitors, and enforces accounting and auditing standards;
- oversees the regulatory activities of the professional accountancy bodies and has specific statutory responsibilities in relation to the regulation of audit; and
- promotes high standards of corporate governance.

The main changes in the FRC's role have been:

- The FRRP has changed from being complaints-driven to actively looking in a risk-based way for failures by U.K. public-listed companies to comply with accounting standards.
- The FRRP will also now review interim financial statements rather than merely annual reports.
- An oversight board will take over the Government's role in monitoring the regulatory activities of the professional bodies, including determining whether their procedures are adequate for their members to retain their statutory status as qualified auditors.
- A new audit inspection unit will monitor the auditors of all listed companies and major public interest entities, with the scope of its work including the "tone at the top" of the major firms and the appropriateness of the judgements on individual audit assignments.

- The board which is responsible for the setting of auditing standards has been given the additional responsibility for setting ethical standards for auditors and is now totally independent of the accountancy profession.
- A new scheme will investigate and, where appropriate, discipline audit firms and individual accountants in cases which involve public interest issues.
- We will keep under review the Combined Code on Corporate Governance which has already been strengthened to increase the influence of independent nonexecutive directors and the professionalism of the way in which Boards operate with, in particular, increased responsibilities of audit committees.

The FRC only assumed its new functions on 1 April and so we are in the early stages of establishing our credibility and authority as a unified regulator. We have already commenced each of our new functions, although some of our new statutory powers await the enactment, likely to be later this year, of a Bill which is currently before the U.K. Parliament.

We believe that the issues of corporate reporting, auditing, professional standards of accountants and corporate governance are all closely related. The capability to look at the issues in a joined-up manner was the rationale for the FRC's new range of responsibilities, which we believe is broader than any of our international counterparts. It means that we are well-placed to implement an effective regulatory regime for the United Kingdom which we hope will command respect in other countries. We believe that our aims are very much aligned with the aims which Congress had in mind when it passed the Sarbanes-Oxley Act.

We are, however, very clear that no system of regulation can ever eliminate the possibility of corporate reporting failures: We believe that it is impossible to achieve zero failure and any attempt to do so would destroy wealth rather than facilitate its creation.

International Convergence of Accounting and Auditing Regulation

The FRC is committed to working toward international convergence of accounting and auditing regulation. This reflects the long history of the United Kingdom as a country whose economic success has been based on international trade. This remains true even though international financial services are now much more important to our economy than the heavy industries of ship-building and steel-making which were once at the heart of the U.K.'s economic power.

The United Kingdom is a major international financial centre, with a share of global capital markets which far exceeds its relative size as an economy: Some aspects of our approach to the operation of those markets must be working well.

International convergence is most commonly discussed in relation to accounting standard-setting, and I will set out the FRC's position on that topic, but there are other aspects of accounting and auditing regulation for which there will be benefits from international convergence.

We share the vision that there should be a single set of high quality accounting standards for use in all of the world's capital markets. We believe that it is important that those standards are set by independent standard-setters, following due process and free from political influence. In this regard, we fully support the work of the International Accounting Standards Board (IASB).

As the Committee will be aware, within the European Union (EU) a Regulation requires listed companies to apply international accounting standards, as endorsed by the EU, in their consolidated financial statements for financial years commencing on or after 1 January 2005. The FRC has a clear and public commitment to the proposition that this means that listed companies should be required to use the full suite of accounting standards published by the IASB.

The process by which international accounting standards will be implemented in the consolidated financial statements of public listed companies in the United Kingdom is wholly dependent on the endorsement of those standards by the EU. The European endorsement process has generally been proceeding well but has run into some difficulties concerning the particular standard on the measurement of financial instruments and at this stage the eventual outcome in relation to that standard remains unclear.

The responsibility in the United Kingdom for the conduct of the negotiations with our European partners rests with the U.K. Government and the FRC has no direct involvement. However, our advice to the Government is that in principle the best outcome is full and immediate endorsement of all of the IASB's standards. In the event that such an outcome is not possible to achieve we have significant concerns about outcomes which involve amending the provisions or scope of the standards published by the IASB. Should one of the IASB's standards not command sufficient support in Europe then a preferred alternative to amending that standard may be to leave it as unendorsed. In either case it is important that those companies who

wish to implement them are permitted to do so. We believe that many British companies will choose to implement the full set of international standards even if they are not required to do so.

We are very encouraged by the expressions of commitment on the part of the authorities in the United States to the process of international convergence. We are supportive of the "Norwalk" agreement between FASB and the IASB which sets out their joint "commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting." We very much hope that the United States can remain committed to that goal, which we believe will be strongly to the long-term benefit of companies and investors in all markets.

The FRC's Accounting Standards Board remains responsible for the standards which apply to entities other than public listed companies. The ASB is committed to full convergence to international standards for U.K. domestic reporting purposes and has been consulting on how best to achieve this goal.

The FRC is also committed to international auditing standards, notwithstanding the fact that there is not yet full support for an international harmonisation project comparable to that for international accounting standards. The FRC's Auditing Practices Board (APB) has in recent years devoted considerable resource to assisting the International Auditing and Assurance Standards Board (IAASB) in its efforts to improve the quality of the international standards.

In order to take advantage of the improved protection against fraudulent financial reporting and aggressive earnings management which recently issued international standards offer, the APB has announced its intention to implement International Standards on Auditing (ISA's) issued by the IAASB in the United Kingdom for 2005 financial statements. The APB believes that adopting the ISA's is a more effective means of improving auditing standards in the United Kingdom than the alternative of rewriting the existing suite of U.K. standards.

The APB recognises that some international standards remain to be revised and it is contributing to that work. In the meantime, the APB also believes that in some respects the existing U.K. standards are stronger than the equivalent ISA. In order to avoid a reduction in the quality of U.K. standards the APB will incorporate some additional material from existing U.K. standards into the ISA's. Examples of areas in which the APB has found it necessary to supplement the international standards include:

- Going concern;
- Related party transactions; and
- Reporting to audit committees.

This additional material will be clearly differentiated from the international material and, over time, the APB hopes to be able to withdraw the additional material as the relevant ISAs are updated by the IAASB.

We believe that there is a risk that the absence of a widely-shared commitment to international auditing standards convergence could lead to a waste of resources on standard-setting around the world plus subsequent inefficiencies caused by audit firms and their clients having to adhere to several sets of standards.

We acknowledge that some jurisdictions may be unwilling to accept auditing standards such as ISA's which do not contain the level of detailed requirements to which they have become accustomed. We believe that the U.K.'s solution to this problem (that is, taking the ISA's as the foundations for U.K. standards but supplementing them with additional requirements which are believed to be appropriate in the domestic market) is a model which other jurisdictions may find attractive. If this model were to be adopted more widely it would have three main advantages:

- improved comparability of standards in different countries;
- reduced cost of domestic standard setting; and
- an easier path to future international convergence.

Standard-setting is, however, only one element of accounting and auditing regulation. Monitoring and enforcement of standards are equally important. Although there have been accounting and auditing standard-setting arrangements for many years, monitoring and enforcement are much less well-established, particularly independent monitoring and enforcement of auditing standards. It is only a year or so since the Sarbanes-Oxley Act established an independent regulator in the United States. It is less than 6 months since the FRC became the independent regulator in the United Kingdom.

The arguments in favour of international standards convergence (that is, the benefits to companies and investors of lowering the costs of cross-border transactions)

apply equally to monitoring and enforcement activities. Indeed, it could be argued that much of the effort devoted to international standards convergence will be wasteful if there are inconsistent or duplicative national approaches to monitoring and enforcement. Inconsistency will constrain the improvements in investor confidence; duplication will increase costs for both companies and investors.

The FRC believes that, whereas a very high degree of international standards convergence is attainable over not too long a period (that is, it is possible to envision a single set of accounting standards in use in all of the world's major capital markets), the nature of the issues to be resolved in relation to monitoring and enforcement convergence mean that our ambitions for international convergence need to be different. The national differences in the factors affecting the design and intensity of monitoring and enforcement activities (for example, companies and securities law, the strength of the accounting profession, the extent to which investors are able to exert influence over companies, etc.) are likely to persist for a long time.

Despite these limitations, we believe that there is merit in pursuing convergence of monitoring and enforcement activities. We believe that there would be considerable benefits for companies and investors if national authorities could take account of the monitoring and enforcement arrangements in other countries when considering what additional procedures need to be applied to foreign registrants and their auditors. Although national authorities will need to make an assessment of the equivalence of the foreign country arrangements, we do not believe that it is either necessary or desirable for those arrangements to be identical in order to be of value. There is, however, no doubt that international agreement on common principles would greatly facilitate cross-border regulatory co-operation.

Given the recent creation of independent audit regulators in a number of countries, and the likelihood of this number increasing in future, we believe that there would be merit in the establishment of an international mechanism to facilitate exchange of information and the development of common principles which would help to reduce the risk of inconsistency or duplication. Such a mechanism would perform a similar role in relation to audit regulation to that performed by the Basel Committee in relation to banking regulation and IOSCO in relation to securities regulation.

Promoting High Standards of Internal Control

One specific recommendation of the 1992 Cadbury Report was that Boards of Directors should "maintain a sound system of internal control to safeguard shareholders' investment and the company's assets." It is worth noting that for this purpose internal control includes not only controls over financial reporting but also "all controls, including financial, operational, compliance controls and risk management." The Code also requires Boards to conduct an annual review of the effectiveness of their internal control system and report to shareholders that they have done so.

In 1999, a group convened by the Institute of Chartered Accountants in England & Wales published guidance (known as the "Turnbull Guidance") for companies on how to implement the provisions of the Combined Code. The Turnbull Guidance is formally annexed to the Code.

The inclusion of a requirement in the Cadbury Report for companies to assess the effectiveness of their internal controls was controversial and there was initially considerable uncertainty and nervousness on the part of companies about the practical implications. As time has past many companies have taken the requirement seriously and we believe that the Combined Code requirement has led to improvements in risk management practices in public companies.

There are two key differences between the requirements of the Combined Code and that of Section 404 of the Sarbanes-Oxley Act. First, under the Combined Code, boards of directors are not required to report to shareholders on the effectiveness of internal control, although they are required to disclose the process applied to deal with material internal control aspects of significant problems disclosed elsewhere in the financial statements. Second, there is no requirement in the Combined Code for auditors to review and report on the effectiveness of the internal control system.

At present in the United Kingdom, although there remains general commitment to the merits of high standards of internal control, there would be considerable anxiety on the part of both companies and investors about the cost implications of any proposal that these requirements be introduced. We will, however, keep the position under review.

The FRC is pleased that the SEC has concluded that the Turnbull Guidance is a framework which is suitable for evaluating internal controls as required by Section 404, even though it is somewhat less detailed in its contents than the COSO framework.

The FRC is aware that there have been a number of developments of best practice in relation to internal control both in the United Kingdom and internationally, particularly as a result of the Sarbanes-Oxley Act, since the Turnbull Guidance was published. In the light of this the FRC has recently announced a review of the guidance. The review group will be chaired by Douglas Flint, Group Finance Director of HSBC Holdings plc who I understand will be appearing before the Committee later today.

PREPARED STATEMENT OF DOUGLAS FLINT

GROUP FINANCE DIRECTOR, HSBC HOLDINGS PLC

Background

HSBC is the largest banking group outside the United States and the second largest in the world measured by market capitalisation. At 3 September the Market Capitalisation was $178 billion. HSBC operates in 76 countries employing some 232,000 staff.

HSBC is subject to primary regulation by the U.K. Financial Services Authority (FSA) on its global operations. As a U.S. Bank Holding Company it is also subject to regulation by the U.S. Federal Reserve. In all it is regulated by approximately 370 different central banks and regulatory authorities at a cost, in aggregate, estimated in 2003 at $400 million.

HSBC is listed on five stock exchanges—the United Kingdom, Hong Kong, New York, Euronext Paris, and Bermuda. The last two arose primarily as a result of acquisitions. The New York listing was obtained in 1999.

HSBC has made two public U.S. company acquisitions since obtaining its New York listing; Republic New York Corporation in 1999 and Household International in 2003.

HSBC is widely held with in excess of 190,000 shareholders. It is estimated some 15 per cent of the shares are held by U.S. investors.

Douglas Flint has been Group Finance Director since 1995 joining from KPMG; a CV is appended to this submission (Appendix I).

HSBC is grateful for the opportunity to contribute to this hearing; the views expressed are personal to Douglas Flint.

Corporate Governance and the Impact of Sarbanes-Oxley

There is no question that there is an immediate and urgent need to reestablish confidence in the public markets through which investors entrust their savings and wealth is created through efficient allocation of resources. The spectacular collapses and outrageous frauds visited on public markets in recent years demanded a public policy response.

It was inevitable that the U.S. response would be first given that the early failures took place in its markets and also that the mechanisms exist for prompt affirmative action. It was also inevitable that the impact of U.S. legislation would be far reaching as it encompassed the global operations of companies listed in the United States, not just their domestic U.S. operations. The threat of litigation in U.S. courts for failure to comply certainly has concentrated minds. It was also inevitable that other jurisdictions would explore their own responses to corporate misdeeds not only in response to the outcry which followed frauds in their own markets, but also to construct frameworks more in keeping with their own domestic governance models.

As a result, companies like HSBC face multiple governance codes and initiatives, some enshrined in law, others in Stock Exchange regulation and others in Best Practice codes. Inevitably there will be conflicts in what is required.

In relation to Sarbanes-Oxley specifically, there is no question that it has reminded boards forcibly of their responsibilities and their accountability for the accuracy of public reporting; that of itself has been an immediate and welcome wake-up call across the world.

It has also reminded companies that the responsibilities they have are direct responsibilities and cannot and should not be "delegated" to third parties such as their auditors or lawyers.

The weaknesses of the auditing profession have also been highlighted which has caused many companies to reappraise the quality of advice they had been relying on, particularly in relation to presentation under U.S. GAAP when it was not their primary accounting model.

However there are unfortunate consequences, perhaps unintended, which may frustrate the overriding objective of the legislation to improve public reporting. Among these I would include the following:

- The way Sarbanes-Oxley is being implemented by the accounting profession following the PCAOB guidance has become meticulously prescriptive and detailed, no doubt in response to fear of litigation for having omitted something, with prescription being seen as the best defence. From the standpoint of the company it feels like having to document everything to prospectus or litigation standard just in case that is the standard decided by the courts to be necessary at some later point in time. The clear danger, increasingly evident, is that the process becomes the objective rather than the means to the end. It worries me that increasing resources in the Big 4 auditing firms are devoted to documenting control processes in companies rather than auditing business by understanding it in the first instance. Good financial reporting comes from understanding the business being portrayed in financial terms far more than understanding the control processes through which the financial results are processed.
- Sarbanes-Oxley necessarily is written in general terms yet is being interpreted to mean or require all manner of things—and there is no-one who can challenge an interpretation with confidence. This is a real issue when implementing Sarbanes-Oxley across multiple geographies as the global accounting firms are not consistent at all in what they do. However, the auditing profession has the final say given that the auditors have been empowered as the sole authority, by virtue of their obligation to report independently on financial reporting controls.
- It is perhaps curious that so much trust is being placed on the judgement of the auditors as regards financial reporting as few have any experience as preparers and the expertise in accounting system design that existed within the firms largely departed when consulting was separated due to conflicts. In a world where directors are rightly subject to increased accountability and greater scrutiny it is worth challenging whether the impact of the independent audit opinion on financial reporting controls improves the process or serves to discourage directors from exercising a judgement that shareholder interests are properly served by expanding/acquiring a business with weak formal financial reporting controls mitigated by sound business model profitability. The existence of some weakness in financial reporting controls is increasingly likely as accounting standards become more prescriptive and complex and require implementation in short timescales across wide geographies with linguistic challenges to training. Accounting officers are therefore becoming increasingly concerned that they are exposing themselves to unknown risk as they seek to implement unfamiliar and complex new requirements. For example, the pending International Accounting Standard on Financial Instruments stretches to over 400 pages with implementation guidance. It would be unsurprising if there were implementation challenges.
- There is a governance penalty now for being U.S. listed which is significant in terms of time and money where the cost benefit is difficult to see. The responsibilities for directors have not changed and they were able to sign their Section 302 certificates in 2003 without the paperchase now being required under Section 404. We estimate some $30–50 million in implementation cost to compile the database of financial reporting controls we know we have but were not originally documented to describe specifically the financial statement control assertion they address. It is interesting also to note the current trend toward private equity investment in many markets where the largest professional shareholders are increasingly making a judgement that higher returns may be available from investments not subject to public reporting obligations/protections.
- Inevitably Sarbanes-Oxley is drafted with a U.S. governance framework in mind and, when taken together with the detailed guidance issued by PCAOB, application internationally is complicated by virtue of different governance models and indeed legal frameworks which can act to frustrate the detailed requirements of the Act but without necessarily impairing the overriding objective. As an international registrant we hope that as time evolves the possibility of mutual recognition of approved governance regimes might be contemplated to avoid costly duplication of demonstrating compliance with equivalent regimes in different formats.

International Financial Reporting Standards (IFRS)

HSBC is a strong supporter of the move toward a globally recognised, robust framework of accounting both for our own reporting and as a consumer of financial information as a lending and investing operation. Partially as a result of the cumulative aggregation of different disclosure requirements across the five jurisdictions through which we are listed, together with increased regulatory requirements our Annual Report in 2003 reached 380 pages of which 40 were devoted to reconciling United Kingdom to U.S. GAAP. With the implementation of IFRS in 2005 requiring explanation of the differences against U.K. GAAP as well as reconciliation to U.S. GAAP we expect the Annual Report and Accounts for that year to grow to around

450 pages which is beyond the comprehension of all but a small segment of the professional analyst community. Indeed, we are concerned that the Annual Report and Accounts has already lost its role as the primary communication medium between management and shareholders.

The training and monitoring burden necessitated as a consequence of multiple GAAP reporting is significant, and is exacerbated as a result of the impact of Sarbanes-Oxley. The impact on accounting system design of requiring data to be held to accommodate tracking of different GAAP reporting is significant and of negligible value to shareholders.

It is clear that shareholders concentrate almost exclusively on the GAAP reporting pertinent to the most liquid market in which shares trade; this suggests there is no "silver bullet" of truth in financial reporting but that consistency and comparability are valued. In the 5 years HSBC has been reconciling to U.S. GAAP, notwithstanding significant differences in reported net income for complex technical reasons in individual years, there has been virtually no shareholder interest in understanding these differences beyond the brief explanations included in the accounts. In professional shareholder face-to-face meetings the subject virtually never arises.

As progress is made in delivering IFRS we have a number of concerns:

- The construction of IFRS is increasingly rules rather than principles based, in part to meet concerns of preparers and auditors that, without definition, criticism could be attracted for the exercise of judgement in interpreting how to apply a standard in nonstandard circumstances; as an aside we note an increasing and regrettable trend in auditing to avoid being seen to apply the intent of accounting standards in face of a possible but bizarre literal application of standards to events which were never contemplated when the standard was designed. Such legalistic construction continues to risk the corruption of accounting and thereby limits the confidence that users will have in financial reporting. Notwithstanding the difficulties involved we believe that there is need for an overriding standard akin to the United Kingdom's "true and fair view" to govern financial reporting permitting, indeed requiring, nonapplication of accounting standards in circumstances where the resulting accounting is materially misleading. Clearly, as in the United Kingdom, full explanation would be required and auditor concurrence or qualification added.

  In this regard I would draw attention to the remarks of Lord Penrose in his report on the collapse of Equitable Life, a significant U.K. life assurer on the dangers of seeking perfection in accounting before requiring change to practices known to be deficient.

  Proposals, exposure drafts, and similar consultation exercises are not a substitute for normative standards. The continuing failure to produce acceptable standards and secure their implementation is a failure in a professional duty owned to the public. It is a failure in duty to shareholders in proprietary companies. It is a failure in duty to policyholders in proprietary and mutual companies. Those with the responsibility to produce appropriate standards must have it impressed on them that what is required are practical standards of general application that will provide consumers of accounting information and their advisers with ready means of assessing the financial positions of the providers of financial products. A search for perfection in his area will fail. To await agreement among the wide range of interests affected will involve interminable delay.

- We are concerned that there is as yet no clear timeframe to disapply reconciliation to U.S. GAAP upon application of IFRS for companies enjoying a secondary listing in the United States. If the real value of IFRS is to be achieved accounts prepared under IFRS must be accepted in all markets without reconciliation. We recognise there is still work to be done to prove the complete and robust nature of IFRS but it would be helpful to have confirmed that following that accreditation the reconciliation burden will be relieved.
- As a matter of policy it would also be helpful if ongoing U.S. requirements rewarded behaviour consistent with the harmonisation agenda, perhaps by reducing the burden of producing comparative information and accelerating relief from reconciliation to U.S. GAAP for registrants who fully adopt IFRS as opposed to those who may take available options to apply restricted versions of IFRS permitted under national discretion.
- We are concerned that although much is being done to harmonise the workflows of the IASB and FASB to ensure increasing convergence as standards are refreshed and updated there are notable differences of timescale in important areas which could lead to frustration of the harmonisation agenda. In particular, we see difficulties in the areas of pension accounting, scope of consolidation and share

based payment. The current difficulties in Europe finalising IAS39 are also illustrative of the theme.

Auditing Standards and Auditor Independence

HSBC regrets intensely the lack of choice in today's public auditing market with the existence of only four global firms a potentially disruptive feature. Unsurprisingly as the firms face similar issues they have a shared interest in acting together thereby evidencing the concentration of power they enjoy. As a global organisation operating in 76 countries we need a single firm to co-ordinate our audit and indeed our regulators demand it.

It is with deep concern that we see the auditing profession flexing its muscles currently within the protection of a statutory and regulatory monopoly for auditing services by threatening withdrawal of service provision to key sectors including banking if they do not receive protection from unlimited liability. I do not believe this is in any way an acceptable position to take but it is one that can only be taken in an oligopolistic industry structure.

The reality for banking organisations is even more extreme as the independence rules operate to exclude the nonincumbent firms from eligibility in the short-term to take on the audit unless significant work is done by both the firm concerned and the bank to maintain independence. Given concentration in the provision of global banking services and the concentration in auditing services, arranging such standby independence is a real commercial problem. Some relief to exclude from the independence rules normal transactions on arms length terms from specified large banking organisations would be welcome and not in my view of public policy concern.

This having been said, we support the auditing profession in its objective of limiting its liability. The potential consequences of further limitation in the supply of auditing services is of concern to us both as a consumer of such services as an audited entity and as a user of audited accounts as a lending organisation. My submission to the Department of Trade and Industry charged with reviewing this matter is appended to this submission (Appendix II). I would draw particular attention to one paragraph.

If auditors are to be allowed to restrict their liability then I believe it is also important that the audit report given is in plain English. Today's report has evolved to a list of exclusions and caveats with the actual opinion the smallest segment of the report. The very technical language used for the audit report gives auditors the ability to claim that everything they did was in accordance with auditing standards and in accordance with the applicable GAAP which is fine, except that it is unclear to the average reader of an annual report and accounts what this means. I believe a longer form report more descriptive of what the auditor actually does would be beneficial both to understanding what the report means and as a way of focusing auditors as to what the primary purpose of the audit is.

This comment draws together much of what is said above in that auditing has increasingly become a technical compliance service which looks to form rather than substance. This undoubtedly is driven by fear of litigation yet I suspect users still believe auditors have taken care to understand the business model as well as verifying that the financial reporting control framework operates effectively. I genuinely believe governance would be more effective if auditors were required to report along the lines set out in Appendix III, which was part of my input to the DTI review in the United Kingdom, as opposed to a technical report referring to their industry standards. Indeed such a report would in my view be more valuable to users than a supporting opinion on financial reporting controls under Sarbanes-Oxley.

Douglas J Flint
Group Finance Director
HSBC Holdings plc

Douglas Flint is Group Finance Director of HSBC Holdings plc.

He began his career with Peat Marwick Mitchell & Co. (now KPMG) where he trained as a chartered accountant. He was appointed a partner of the firm in 1988.

Mr Flint specialised in banking, multinational financial reporting, treasury and securities trading operations, group re-organisations and litigation support while at KPMG. He joined the HSBC Group as Group Finance Director-Designate on 30 September 1995 and was appointed to the Board on 1 December 1995.

He is a Director of HSBC Bank Malaysia Berhad.

Mr Flint was born in Scotland in July 1955 and was educated at Glasgow University where he gained a B.ACC (Hons) degree. He also completed the PMD course at Harvard Business School in 1983.

He is a member of the Accounting Standards Board and on the Advisory Council of the International Accounting Standards Board and Chairman of the Financial Reporting Council's review of the Turnbull Guidance on Internal Control. He is also a member of the Institute of Chartered Accountants of Scotland and the Association of Corporate Treasurers. He is a Fellow of The Chartered Institute of Management Accountants. He also served on the Shipley Working Group on Public Disclosure. Mr Flint's hobbies are golf and tennis.

Group Corporate Affairs
July 2004

James Carey, Esq
Corporate Law and Governance Department
Department of Trade and Industry,
1 Victoria Street
London SW1H OET

12 March 2004

Dear Mr Carey,

DIRECTORS AND AUDITORS LIABILITY CONSULTATIVE DOCUMENT

In response to the invitation to comment on the above, I have set out below comments restricted to the position of Auditor Liability.

By way of background HSBC is today the second largest company listed in the UK with a market capitalisation of £92 billion. We operate in 79 countries and reported earnings attributable to shareholders of US$8.8 billion for 2003 on 1 March. Our annual audit fees for 2003 were US$36.3 million which I believe is the highest fee paid by any UK company.

I believe the issue of Auditor Liability is a serious one and one where revisions have to be made if we are to retain a robust and credible audit profession globally. This matters to us not only in relation to our own shareholders but as a major lending institution it is important that the integrity of financial reporting is protected through there being an effective audit profession.

Barriers to Entry and Choice

In my opinion there are clear substantive barriers to entry to, and expansion within, the auditing market particularly as it relates to public interest companies, that is those private companies above a certain size and all listed companies. These barriers relate to training, organisation, international connection, credibility and risk management within which unlimited liability is the most serious barrier. Even if a limitation of liability were put in place I believe the other barriers are such that it would still be very difficult for a new entrant to make any impact on the large end of the auditing market as without the credibility of a track record it would be very difficult to see how any public company could appoint an unknown quantity.

There is today already insufficient choice between firms and this is particularly so in the financial industry where the independence rules are so restrictive that almost by definition all of the firms who are not the current auditor have real independence issues. Furthermore, if individuals working in accounting firms are to be allowed to have relationships with financial institutions, by definition there will be virtually no choice, without significant disruption in changing from the incumbent auditor. There is a need to look separately at those independence rules as they relate to routine banking services (current accounts, mortgages and credit cards) but that is another subject.

If we were to lose another major accounting firm it would be a serious problem.

Arguments by the Largest Auditors

I noted with interest the arguments put forward and agree with most of them. However I think there are a number of inconsistencies in what has been said. In my view it is not at all damaging that there is a trend to exit from high risk companies as it seems to me that all businesses should seek to restrict commercial relationships with high risk counter-parties, particularly when contingent liability may arise through such association. In our business we routinely avoid dealings with companies and individuals who fall outside our risk appetite. It would be a perverse result indeed if limiting auditor liability encouraged auditors to accept high risk companies on the basis that the down-side was protected. It would be far better that high risk companies had to reform themselves sufficiently to be eligible for audit service from a 'premium brand' auditor as this discipline would improve the quality of capital markets.

I also find it a curious argument that international networks may not come to the aid of partnerships in difficulty in another country. The audit profession has so far as its clients are concerned sought to put itself forward as a global service provider. Certainly we have taken the view that we are engaging one firm when we appoint auditors and not a separate firm in each country where audits are conducted.

What I do think however is relevant for the DTI to consider is that if liability turns out to be truly global and does not respect the different local partnerships and structures which have been established then the UK audit profession is exposed to the risk of failure as a result of awards made in punitive legal systems in another country which capture for shareholders in that country (and their lawyers) the entire global value of the major firm involved.

Insurance

From our own experience in renewing and maintaining professional indemnity cover there is clear evidence that liability insurance is increasingly available only on extremely restrictive terms and at reducing levels of cover. In reality it is getting to the point where the terms of such insurance make it very difficult to justify seeking such cover as it is not clear that it would respond in the circumstances envisaged.

As a result of this and as a result of increasingly rule based accounting standards there is clear trend towards technical or defensive auditing which is ever more directed towards documenting, ab initio, a defence that would stand up any court in respect of each audit decision taken on every minute aspect of the accounts, as opposed to considering more broadly the 'true and fair view' of the profit and of the financial position.

This will over time lead in my view to auditors that do not have the experience to make the quality of judgements required to be an effective auditor and leave companies and their shareholders with "box-tickers" who assess compliance with a lexicon of accounting rules but do not understand whether the result of such 'compliance' makes sense.

The fact that no audit firm has yet collapsed as a result of a claim made against it in the UK is probably only a matter of timing and it would be improper to be complacent that because it has not happened it could not happen. We have to remember that the UK economy has been very successful in the last decade, did not have within it the telecoms and tech sector companies that contributed to the major scandals in the US and poor auditing usually comes to light most vividly in an economic downturn other than in cases of fraud.

Possible Solutions

I believe the most appropriate response is Option C in the Consultative Paper which allows auditors to limit their liability contractually, subject to rules being set by the Secretary of State. I think it is particularly important that legislation should cover the minimum multiple of the audit fee, as without legislation there is a clear incentive for the four firms to stand together with a low multiple. I believe that the appropriate multiple is of the audit fee alone rather than all other fees or as a multiple of the turnover of the auditors as it would focus shareholders' attention as to how much is being paid for the audit and therefore what degree of work is being done Clearly somebody who only pays £100 for an audit cannot expect to have got very much in return and therefore they should not have much ability to recover for having allowed such a weak audit to be undertaken. In my judgement the minimum multiple has to be at least 10 times to be meaningful.

Alongside this of course would need to be governance ensuring that fees to the auditors were not transferred to non-audit engagements and I envisage a world in the future where there is an ever more restrictive list of services that auditors can provide.

The Audit Report

If auditors are to be allowed to restrict their liability then I believe it is also important that the audit report given is in plain English. Today's report has evolved to a list of exclusions and caveats with the actual opinion the smallest segment of the report. The very technical language used for the audit report gives auditors the ability to claim that everything they did was in accordance with auditing standards and in accordance with the applicable GAAP which is fine, except that it is unclear to the average reader of an annual report and accounts what this means. I believe a longer form report more descriptive of what the auditor actually does would be beneficial both to understanding what the report means and as a way of focusing auditors as to what the primary purpose of the audit is.

I have set out in an attachment to this email suggested areas which might be covered. The language is very draft and purely to make a directional suggestion. The matters covered are drawn from the ASB's "Exposure Draft on the Operating and Financial Review" and the PCAOB's guidance for the purpose of Sarbanes-Oxley.

I also believe consideration should be given to making the individual audit directors/partners who take responsibility on behalf of their firms to sign the report personally on behalf of the firm as again I believe that gives much clearer accountability for the audit report.

I would be pleased to discuss this submission if you would find it helpful.

Yours sincerely

Douglas J Flint
Group Finance Director

APPENDIX III

'INDEPENDENT AUDITORS' REPORT

We have audited the Financial Statements on pages x to y.

In planning our audit of ABC plc we have considered to the extent necessary to form an opinion on the accounts the nature of the company's business, its objectives, the strategies adopted to achieve these objectives and its competitive position in the markets in which it operates.

We have also obtained an understanding of, and evaluated, management's process for assessing the effectiveness of the company's internal controls over financial reporting. In particular we have considered and tested the following controls, for which management is responsible, which cover:

- Relevant assertions related to significant accounts and disclosures in the financial statements.

- Controls over initiating, authorising, recording, processing and reporting significant accounts and disclosures and related assertions embodied in the financial statements.

- Controls over the selection and application of accounting polices that are in conformity with generally accepted accounting principles.

- Antifraud programmes and controls.

- Controls, including information technology general controls, on which other controls are dependent.

- Controls over significant non-routine and non-systematic transactions, such as accounts involving judgements and estimates.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorise, record and process journal entries in the general ledger; and to record recurring and non-recurring adjustments to the financial statements.

In our opinion:

- the performance of the company for the year ended 31 December, 2____, is fairly represented in the Financial Statements set out on pages x to x;

- The Financial Statements and financial disclosures and notes, taken together with the management discussion and analysis on pages x to x disclose fairly the main influences on performance and highlight the trends important to an analysis of the company's business model.

- The Financial Statements and financial disclosures and notes, taken together with the management discussion and analyses on pages x to x give a true and fair view of the financial position of the company and highlight factors affecting, or likely to affect, that position.

XYZ Audit plc

PREPARED STATEMENT OF ARNOLD C. HANISH

CHIEF ACCOUNTING OFFICER, ELI LILLY & COMPANY

SEPTEMBER 9, 2004

Thank you Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee for this opportunity to appear before you today.

My name is Arnold Hanish and I am the Chief Accounting Officer for Eli Lilly & Company. I am here this afternoon as Vice Chairman of Financial Executives International's (FEI's) Committee on Corporate Reporting (CCR). FEI is the leading advocate for the views of corporate financial management, representing financial executives who hold positions of critical importance in the integrity of financial reporting, such as chief financial officers, treasurers, and controllers. We take this responsibility very seriously, and I am pleased to have the opportunity to share our views with you today on the important issue of the impact of the Sarbanes-Oxley Act (the Act). My remarks will largely focus on Section 404 of the Act, which addresses internal control over financial reporting.[1]

Strengthening Corporate Governance, Internal Controls

First, FEI strongly supports the goals of the Sarbanes-Oxley Act, as it has enhanced the role of corporate financial executives and created a greater appreciation for that role within the corporate environment and among the public generally. It has also strengthened the ability of financial executives to institute continuous improvements in internal controls and financial reporting, and to gain enhanced buy-in by all employees of the need for strong internal controls. Specifically, the Act has resulted in the following positive developments:

- Strengthening the tone at the top by requiring certifications of financial statements by CEO's and CFO's, and by requiring management and auditors' reports on internal controls over financial reporting.
- Strengthening the incentives for high quality financial reporting that can be relied upon by the public, by increasing penalties for doing otherwise, including, importantly, the Federal sentencing guidelines for criminal conduct in connection with fraudulent financial reporting.
- Strengthening the requirements for audit committees, which play such a critical role in corporate governance on behalf of the investing public. We are particularly pleased to see enhanced requirements for independence of the members of audit committees, financial literacy requirements to enable them to better understand and participate in the corporate governance process, and to engage committee members more actively in the audit committee meetings. In addition, the length and frequency of audit committee meetings have increased as a result of Sarbanes-Oxley, ,which is a positive result for corporate governance and the investing public.
  - At my own company, Eli Lilly & Co., we have held education sessions for members of our audit committee to build their awareness of important accounting and reporting issues and their financial accounting expertise. In addition, the number of audit committee meetings has increased from 4 to 9 per year, with a corresponding increase in length of the meetings.
- Making the internal control process more rigorous, and heightening accountability.
- Limiting transactions such as loans to officers, which is part and parcel of good corporate governance.
- Strengthening the ability of accounting professionals to look at all levels of reporting deficiencies, multidimensionally; that is, individually and collectively, and in a particular time period, as well as cumulatively over time. Further, the Act has raised the bar on the need to correct deficiencies in a timely manner. As such, the Act has increased the awareness of all levels of employees about internal control deficiencies and the need to correct them before they become significant deficiencies or material weaknesses.

Before Sarbanes-Oxley, companies had internal control processes in place, tested them, and corrected deficiencies. Companies have long had what are referred to as "management letters" from their auditors in which certain internal control weaknesses are noted, in addition to reports of their internal audit staff. In addition,

[1] FEI was among the first organizations to make constructive comments to Congress by issuing, in March 2002, "FEI['s] Observations and Recommendations [on] Improving Financial Management, Financial Reporting & Corporate Governance." Several of these recommendations were ultimately incorporated in the Sarbanes-Oxley Act. (Attachment 1).

companies in regulated industries such as mine, are subject to an additional level of inspection from their respective regulators, and receive reports from their regulators on internal control related matters. These inspection reports are in addition to management reports from their internal and external auditor. In this regard, the advent of the Act has not added something entirely new, particularly for highly regulated industries. But, it has added gravitas to the impact of any reports of substantive internal control weaknesses and the need to correct them by raising the bar of public disclosure of material weaknesses. Public companies must take appropriate action to issue "clean" reports, that is, showing that the system of internal control over financial reporting is "effective," and without material weaknesses. At the same time, the criminal penalties provide a strong disincentive for fraudulent attempts to circumvent these requirements.

As such, we believe the heightened emphasis on internal controls, corporate governance, and the enhanced role of financial executives in this process, have all been very positive outcomes of the Sarbanes-Oxley Act.

However, there are growing concerns by many FEI members about particular issues that are becoming increasingly evident now that we have the benefit of real experience in implementing the Act. The remainder of my statement will address these issues.

Substance Over Form

FEI would like to suggest some important guidelines, based on its members' experiences in implementing the SEC, PCAOB, and listing standards resulting from Sarbanes-Oxley.

Testing of Internal Control Must Follow Standard of "Reasonable Assurance"

The SEC and PCAOB rules implementing Sarbanes-Oxley allow for testing and assessments of internal control over financial reporting in line with the long-held standard of "reasonable assurance." The concept of "reasonable assurance" has been chosen over "absolute assurance" because the cost of obtaining "absolute assurance" if there even is such a thing would be astronomical, and some debate whether Sarbanes-Oxley as written is so costly as to be causing some public companies to go private, or deterring private companies from going public. Thankfully, the Sarbanes-Oxley Act and the resulting regulations did not seek "absolute assurance" regarding internal controls, but there remains a fine line being walked by preparers and auditors between "reasonable assurance" and "absolute assurance."

In addition, while the Sarbanes-Oxley Act was created to try to prevent the kinds of egregious financial reporting fraud that flashed across the headlines, it is important to recognize that internal control and documentation alone will not necessarily eliminate or remove the risk to financial reporting posed by management override. It is integrity, above all, that will be the driving force in combating fraudulent financial reporting. And it is the threat of being paraded across the television screen in handcuffs, and the dual threat of increased jail time, that serves as the strongest deterrent to financial reporting fraud, not the many levels of documentation which can become an end in itself, rather than a means serving an end, to support high quality, reliable financial reporting.

Documentation can Supplement, but will not Supplant, Judgment and Honesty

This is the area in which FEI would like to stress the fundamental concept that has held the test of time, which is generally referred to as "substance over form." In the rush to implement Sarbanes-Oxley, there has developed what seems to be an overemphasis on certain additional or duplicative levels of documentation, with a declining value in terms of how much that additional documentation would add to the effectiveness of internal control.

Let me give you an example where the focus on documentation is so great, it seems to be overcoming the focus on the substance of the matter being documented. If a meeting of a company's disclosure committee is held to discuss a financial reporting matter, in our new post-Sarbanes-Oxley world, there can be so much focus on testing for documentation that the meeting was held, that there is insufficient attention paid to reviewing the substantive nature of what was discussed. The reason why the meeting was held can be overshadowed by the need to search for a piece of paper documenting that meeting.

- There are, of course, additional burdens on companies with multinational operations, in extrapolating these controls, testing and documentation. At my company, we had tried to "spread the pain" by moving it from the top down through divisions and subsidiaries, to the ultimate process owners. Some would argue that the processes were fine and the controls were in place, but we now must go through what some believe are documentation exercises that are bordering on the

excessive and do not serve the intent of Sarbanes-Oxley. Many gaps identified related again to the signoff or documentation that an activity took place.

- In grappling with implementation of the Act, some are falling into the trap of overemphasizing form over substance, which ultimately is a use of time and resources that does not benefit the reliability of internal control, and does not benefit investors.

Make no mistake about it, documentation for documentation's sake will not deter financial fraud. In reality, the increased sentencing guidelines will probably provide the single-most important disincentive for committing material financial reporting fraud. As we all move to implement the SEC and PCAOB standards under the Sarbanes-Oxley Act, we must remember that documentation should supplement, but does not supplant, management's judgment, integrity, and honesty.

Cost-Benefit of Implementation

Let me address the overall cost-benefit of the Sarbanes-Oxley Act. The degree of testing and documentation of internal controls forms the largest part of the cost, and incorporates the need to pay internal staff, both finance and internal audit, as well as the external auditor, and other external experts such as software consultants and so forth, to enhance systems related to testing, documenting, and reporting on internal controls. The benefit side of the equation, while it includes the strengthening of the role of the financial reporting and internal control process and individuals involved in that process, is still largely an intangible benefit, always more difficult to measure and quantify, such as "increased shareholder confidence." And while FEI certainly supports such benefits, we believe that part of good corporate governance encompasses not only strong internal controls, but also an eye toward budget, profitability, and as such, cost-benefit issues.

When the Act and resulting SEC and PCAOB standards were being drafted, FEI urged regulators to maintain flexibility and judgment that would promote efficiencies rather than redundancies, and minimize extraneous, labor-intensive procedures that were time consuming and expensive. Now that companies have 1 year of implementation behind them, FEI is hopeful that reasonable approaches will be developed that will make future year compliance of the Sarbanes-Oxley Section 404 less costly. However, whether it will be less costly, of course, remains to be seen, but it is our hope that reasonableness will prevail, particularly in the roll forward of continuous testing and documentation in future years after this first year baseline is established.

Over the past 2 years since the Sarbanes-Oxley Act was passed, FEI has surveyed its membership as to expected costs for implementing Section 404 of the Act. I have attached a copy of the January 2004 and July 2004 survey results to my testimony.[2]

FEI's Cost Survey on Implementing Section 404

FEI's most recent survey of the cost of implementing Sarbanes-Oxley Section 404 was conducted in July 2004. FEI surveyed 224 public companies, with average revenues of $2.5 billion, (the range being under $100 million to over $5 billion in revenues) to gauge Section 404 compliance cost estimates. Highlights of survey results are as follows:

- The total cost of compliance with Sarbanes-Oxley Section 404 is now estimated at $3.14 million for the average company.
- This represents a 62 percent increase versus the earlier estimate, from our January 2004 survey, of $1.92 million for the average company.
- We anticipate these estimated costs for Year One implementation will continue to rise as we close out this first year of implementation.

Breaking down the overall 62 percent increase in estimated costs between the January and July estimates, we saw a 109 percent rise in estimated internal costs (such as internal audit and other internal costs), a 42 percent jump in external costs other than the auditor (such as, costs of external consultants and software packages), and a 40 percent increase in estimated audit fees attributable specifically to the 404 internal control attestation. In total, companies surveyed estimate a total incremental increase in audit fees of 53 percent for the attestation on internal control over financial reporting, versus their annual audit fee for their financial statement audit. In raw dollars, this represents an incremental audit fee estimated at $823,200 for the audit of internal control over financial reporting, for the average company.

[2] See Attachments 2 and 3 for results of the January 2004 and July 2004 FEI surveys, respectively.

Small Company Concerns

While all companies are feeling the impact of the Sarbanes-Oxley Act on their bottom line, FEI recognizes the concern about the impact the statute will have on smaller companies. At my company, I am fortunate to have an extremely competent staff of CPA's with 5–10 years experience, but many smaller companies do not have a staff of that level of depth and breadth, these smaller companies do not always have excess resources to pull from, and potential costs of outsourcing these services could be particularly burdensome. And while FEI's survey of 224 companies did not indicate a disproportionate impact on smaller companies, logic tells me that this is an area that should be closely monitored for a burden that may be too great, and where the costs are so high, that being a public company may not seem to justify the costs.

Regulators and Cost-Benefit Concerns

As a result of the passage of Sarbanes-Oxley in July 2002, there has been an extremely high volume of rules, regulations, accounting and audit standards generated. This "regulation overload" required by the Act, has been created because all the regulations and standards became effective within a relatively short period of time. It has been a huge struggle for companies and auditors to digest all these new regulations and standards let alone implement them. FEI wants to acknowledge the efforts on the part of the regulators and standard-setters for not only recognizing this "regulation overload," but also for taking steps to provide relief.

SEC

FEI would also like to point out and acknowledge the SEC's recognition of the burden its accelerated filing deadlines for 10–K's and 10–Q's proposal could have placed on some companies, and the Commission's willingness to postpone final implementation of the accelerated filing deadlines to allow companies to devote their resources to Sarbanes-Oxley Section 404 implementation.

FEI would further like to acknowledge the SEC's efforts to provide additional implementation guidance on its Sarbanes-Oxley Section 404 related rulemaking by issuing their Frequently Asked Questions or "FAQ" document in June which provided additional guidance. This guidance has proven to be extremely helpful to both preparers and auditors as they work to comply with Section 404 requirements.

PCAOB

Similarly, FEI would like to acknowledge the efforts of the PCAOB, in their issuance of implementation guidance relating to their respective standard on the audit of internal control over financial reporting, in the form of Staff Questions & Answers or "Q&A's" issued by the PCAOB in June. We applaud these efforts to issue implementation guidance to clarify standards and thereby reduce implementation burdens. At the same time, we believe that such guidance should not preempt the amount of flexibility and principles-based approach that is necessary for substantive implementation of the rules envisioned under the Act. That is, regulators should not take an overly rules-based approach as they contemplate standards.

FASB

The private-sector standard-setter, the FASB, also has a fundamental requirement to consider the cost-benefit of its rules, and to seek to issue standards that can reasonably be implemented. FEI's Committee on Corporate Reporting (CCR), supports the private-sector standard-setting process, and sent a letter of such support earlier this year.

We appreciate the role that the private sector can play in the standard-setting process, and we take an active role in commenting on proposed standards as well as participating on FASB task forces and advisory bodies. The main general concern we have recently expressed to the FASB, is that they need to follow careful and thoughtful due process in developing standards, and that sufficient time be allowed for comment on proposed standards, and for implementation of final standards. This concern has been especially great during Sarbanes-Oxley implementation, including, but not limited to, Section 404, and the myriad of SEC and PCAOB rules that have been promulgated as a result of the Act. We hold periodic discussions with members of the FASB, and have strongly encouraged them to be reasonable in allowing sufficient time for its constituents to give thoughtful analysis to proposed standards, and that they consider major reporting deadlines when they issue proposed and final standards.

We have also commented about the volume of proposed standards and recently finalized standards that require more attention from management and auditors, and are also of keen interest to users of financial statements. For this year-end in particular, we have strongly encouraged the FASB to avoid requiring the year-end im-

plementation of standards issued in the fourth quarter, in order to provide sufficient time to implement those standards. We have discussed with the FASB that just because an Exposure Draft of a proposed standard has been out for a substantial period, does not mean that companies would be prepared to implement that Exposure Draft quickly, should the FASB decide to issue a final standard. As is often the case with many FASB standards, the final standard often differs sufficiently from the Exposure Draft, that it requires wholesale changes in implementation versus what would have been required for the Exposure Draft.

We would like to acknowledge the FASB's recent decision to extend due process on its Revenue Recognition project, due to a significant change in the project's scope. We asked the FASB to allow for more time to consider and provide feedback on the direction the project is headed, and wish to thank the FASB for their recent decision to provide the opportunity for more thoughtful contemplation and discussion of the underlying concepts being considered. We believe this delay will allow companies to focus on Sarbanes-Oxley implementation this year, and will bring the FASB's deliberations on revenue recognition into a more parallel mode with the IASB, which plans to issue a preliminary views document on revenue recognition later this year. (The FASB similarly recently decided to issue a preliminary views document as a first step.)

Conclusion: The Need for Internal Control and Innovation

Unquestionably, FEI continues to fully support the spirit and intent of Sarbanes-Oxley. FEI believes that the statute has strengthened the role of financial reporting and internal control and, in doing so, has strengthened confidence in the capital markets.

In closing, let me share a story about the founder of my company, Colonel Eli Lilly, and what I believe he might have thought of the Sarbanes-Oxley Act. A veteran of the Civil War, Colonel Eli Lilly was also a pharmacist, and was highly concerned about a common practice of his era—that people would purchase purported medicines with no verification of safety or effectiveness. In response to that state of affairs, Colonel Lilly chose to start his own small company. His goal was to produce medicines that passed high standards and protected the public's health, safety, and interest. He further believed that medicine should most properly be purchased on the advice of doctors, not from traveling salesmen.

From this beginning, quality control and its counterpart, internal control, have always been a part of Lilly's tradition. And it is the same way for my counterparts in FEI.

But in addition to its emphasis on quality control, Eli Lilly & Co. is also known for another major tradition: innovation. As with so many organizations, the pursuit of quality improvement led directly to the quest for major advances that would be new and better. Our products, as those of our peer companies in FEI and beyond, help raise the quality of life and standard of living in the United States and around the world.

If Colonel Eli Lilly were here today, my guess is he would probably applaud the Sarbanes-Oxley Act for its emphasis on internal controls in providing quality assurance in financial reporting. He would recognize the role of the external auditor in providing third party, independent attestations on these financial reports. But he would also remind people of the importance of innovation. We cannot lose sight of the forest for the trees. We must not let internal control testing and related documentation take over so much of our time that we lose focus on the operational and strategic planning on which our companies and the stakeholders depend.

That concludes my remarks. I would like to thank the Chairman and the Members of the Committee for allowing FEI the opportunity to testify.

Attachment 1: FEI Observations & Recommendations

March 2002

fei financial executives international

financial executives international

FEI Observations and Recommendations

Improving Financial Management, Financial Reporting and Corporate Governance

Overview

Presented here are the views of Financial Executives International (FEI) on reforms aimed at strengthening financial management, reporting and corporate governance. We believe that most companies are governed and managed ethically and are fulfilling their fiduciary obligations to their stakeholders. However, the investing public and FEI share a common concern over the problems highlighted by the recent failures of corporate management, financial reporting, corporate governance, audit committees and independent audits. The U.S. capital markets are based, in large part, on trust in a checks-and-balances control system fundamental to good corporate governance. The weaknesses exposed in the system are highlighted in public documents, testimony before Congress, press interviews and special reports. We believe these revelations point to certain systemic issues and call for reform. FEI supports a clear and coordinated look at all areas of possible improvement. It is our intention to assist in this effort by making the following observations and recommendations.

We believe the following factors may have contributed to the recent problems observed in the areas of corporate governance, ethical management, financial reporting and external audits:

- Lack of ethical conduct and inappropriate "tone at the top"
- Failure of effective board oversight
- Lack of financial expertise on audit committees
- External audit failure due to compromised independence and failed quality control procedures
- Overly complex accounting standards
- Opaque financial reporting
- Emphasis on form over substance in applying accounting standards

We offer recommendations in four areas:

Strengthening financial management and commitment to ethical conduct

Rebuilding confidence in financial reporting, the accounting industry and the effectiveness of the audit process

Modernizing financial reporting, and reforming the accounting standards-setting process

Improving corporate governance and the effectiveness of audit committees

Recommendations

Strengthening Financial Management and Commitment to Ethical Conduct

Recommendation 1: All financial executives should adhere to a specialized code of ethical conduct.

FEI recommends that all senior financial professionals be required to adhere to a strong ethical code of conduct. For many years, members of FEI have signed such a code, thus committing to its principles. That code has been updated recently to include a call for all financial executives to acknowledge their affirmative duty to proactively *promote* ethical conduct in their organizations.

Whether or not they are members of FEI, all finance professionals should adhere to a code of ethical conduct containing all the elements of the FEI Code of Ethics. The Code states, for example, that financial arrangements involving actual or apparent conflicts of interest should be avoided.

FEI recommends that all senior financial officers, accounting officers, controllers, treasurers and chief investor relations officers annually sign a code containing all the elements of the FEI Code of Ethics and deliver it to their board or the board's designated committee. Further, we expect that best practice in this area will be that **all** finance, accounting, tax and investor relations personnel annually sign such a code.

The FEI Code is attached to this document as Appendix A.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 2: Companies should actively promote ethical behavior and provide employees with the means to report perceived violations of ethical standards without fear of reprisal.

FEI strongly endorses practices by which all companies adopt a code of conduct for their employees and conduct regular training sessions to assure understanding and compliance. We believe companies should provide support and broad protection to employees reporting code of conduct violations. Under such a framework, companies should:

- Adopt a written code of conduct for all employees
- Conduct employee orientation and training with respect to the code
- Provide employees with a mechanism (such as a hotline or help-line) to surface concerns about compliance with laws and regulations
- Adopt procedures for voluntary disclosure of violations of laws
- Participate in best practices forums
- Inform the public of the active commitment to implement these steps

We encourage all companies to set up "hotline" channels, providing employees with the means to report perceived violations of the code or of the law without fear of reprisal. Additionally, employees should be made aware of these lines of communication and be assured that the source of all calls will be kept confidential. Calls should go directly to a person, facilitator or committee specifically identified by the company's board. That designated person or entity should screen each call and initiate appropriate action within the company. The company's board of directors should be informed of calls made and their disposition on a regular basis.

Recommendation 3: Qualifications of the principal financial officer and principal accounting officer.

Management, in support of the audit committee and board of directors, should designate a principal financial officer and a principal accounting officer as those terms are used in the Securities Act of 1933. FEI believes the qualifications and roles of such persons should include the following:

- The principal financial officer should be that person with overall responsibility for the finance function within the reporting company, and should have knowledge in all areas of finance including, at a minimum, the requisite knowledge proposed for the financial experts of audit committees. The principal financial officer should be responsible for upholding compliance with ethical standards within the finance function.

- The principal accounting officer should be a licensed public accountant or possess equivalent knowledge and experience, and should be current and knowledgeable in the understanding of GAAP and the SEC's rules and regulations governing the preparation and audit of financial statements.

- The principal financial officer should report to the chief executive officer, and the principal accounting officer should report to the principal financial officer. It is further recommended that the principal financial officer and/or the principal accounting officer meet with the audit committee periodically (quarterly) to review significant financial statement issues, including key judgments, estimates and disclosure matters.

Rebuilding Confidence in Financial Reporting, the Accounting Industry and Effectiveness of the Audit Process

Recommendation 4: Create a new oversight body for the accounting profession staffed with finance and accounting professionals.

Enhanced oversight of public accounting firms by an independent body would increase public confidence in the audit process and effectiveness of the audit quality control process. This oversight board should be sponsored by the SEC and, recognizing the technical nature involved and the need to adequately understand the audit process, the majority of its members should be executives with knowledge in accounting and finance. These individuals should be clearly independent of public accounting firms or other audit industry organizations. We do not believe that a majority of members should be drawn from the audit profession.

This oversight board should oversee the peer review quality control process of the audit firms. Furthermore, the peer reviewers should be accountable to the oversight board for the scope of review, findings, recommendations and corrective actions.

We further recommend that a focused mission and scope will enhance the effectiveness of this body. Therefore, this new body should be principally tasked with the job of audit industry oversight and discipline. As FEI continues to support private-sector accounting standard setting, we believe that a separate and independent body should continue to oversee the FASB.

Recommendation 5: Place restrictions on certain non-audit services supplied by the independent auditor.

Even the appearance of a potential conflict of interest may now undermine an auditor's effectiveness. Therefore, we believe confidence in the integrity of the audit would be enhanced if certain non-audit services were prohibited for audit clients. In this regard:

- The independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.
- Advisory services should be prohibited wherever the audit firm could be put in a position of relying on the work product resulting from such services.
- Tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits should be acceptable services for audit clients as they would not normally raise questions of conflict of interest. In the unusual instance where such services could present questions of a conflict of interest, such services should not be provided.

Importantly, in addition to the foregoing, we suggest that audit committees approve substantially all large non-audit services. In so doing, the audit committee should consider the impact of such services on the overall independence of the audit firm.

FEI also recommends that the SEC redefine the current classifications of audit and non-audit services to assure that the guidance is clear and that the distinction conveys a complete and meaningful picture to investors in regard to the proper characterization of audit and non-audit activities.

Recommendation 6: Restrict the hiring of senior personnel from the external auditor.

FEI recommends that companies adopt policies that restrict the hiring of engagement audit and tax partners, or senior audit and tax managers, who have worked on the company's audit for a period specified by the board of directors. FEI believes that this period should be no shorter than two years.

Modernizing Financial Reporting and Reforming the Accounting Standards-Setting Process

Recommendation 7: Reform the Financial Accounting Standards Board (FASB).

FEI recommends that a "Blue Ribbon Committee" be formed to address FASB reform. While we support continuing private-sector standard setting through the FASB, substantive process and structural changes are long overdue. The Blue Ribbon Committee should complete its work promptly and produce initial recommendations within three months of its formation. The Committee should be guided by the basic principle of advancing financial reporting, notwithstanding divergent political interests. The Committee should address the following issues:

- FASB Organization
  - Board mission statement
  - Size of board
  - Length of board member terms
  - Voting majority
  - Staff effectiveness, accountability and structure
  - Restrictions on board member meetings ("Sunshine Rules")

- Timely Standard Setting
  - Timely standard setting with clearly defined priorities, objectives and milestones
  - Agenda management and accountability

- Financial Statement Content
  - A process for defining clear long-term objectives for financial statements produced under GAAP
  - Fair value accounting, in particular, needs to be addressed, given the absence of market values in many areas and the potential for such accounting concepts to create financial statement volatility

- Financial Accounting Standards
  - Reassess the conceptual framework as the basis for standard setting
  - Assure practical implementation of principle-based standards vs. specific, bright-line rules; examples of standard application and financial interpretations based on principles underlying standard
  - Impact of planned globalization of accounting standards
  - Review existing standards and disclosures
  - Address the need to increase the participation of the user and investment community and decrease tension with the preparer community

Recommendation 8: Modernize financial reporting.

FEI expresses strong support for the following improvements in financial reporting and recommends that committees be formed promptly to address these matters.

- Improve Management's Discussion and Analysis (MD&A)
  - FEI should take the lead in developing best practices for MD&A disclosure utilizing 2001 annual reports as a primary source for data.

- Implement "Plain English" financial reporting as the new language of professionals involved in investor relations and financial statement preparation.

- Promote voluntary disclosures of business performance metrics
  - FEI recommends that companies consider providing Web-based reporting of key performance measures used by management and specific to the industry on a quarterly basis. (A possible source for additional key performance measures is information shared at analyst presentations.)
  - In order to encourage the expansion of reporting additional measures, it is essential that safe harbor rules be strengthened to specifically encompass the additional reporting.

- Develop and complement Web-based financial reporting
  - Internet delivery of hierarchical financial reporting that employs scorecards, current key performance indicators and analytical tools offering differing accounting standards is the future. Industry, users and the SEC should move ahead aggressively to develop models of such reporting frameworks without reducing access for investors in the short term.
  - Mandatory Internet access to financial reports — public companies should make the information available on their Web sites concurrent with SEC filings.
  - Voluntary business performance reporting, discussed above, may be more easily implemented through Web-based reporting.

- Expanded use of reports on Form 8-K
  - Items typically included in these filings could be expanded; however, the SEC's revised guidance should be "principle-based" and the current list of additional items to be disclosed should be presented only as "examples."

- Enhance filing requirements for foreign filers
  - Many foreign filers currently provide quarterly financial statements on a voluntary basis. FEI recommends that the SEC require foreign filers to file quarterly.

- Assess transition impact on paper documents
  - FEI does not suggest that hard copy mailings be eliminated in the near term. However, the content of paper mailings to shareholders should be examined to determine what modifications can be made and over what timeframe.
  - Financial disclosure to shareholders via paper documents has vastly exceeded a user's ability to digest it. The availability of public filings on the Web and analysis of information accessed by users should assist in identifying what is considered important. The resulting information could serve as a basis to expand the disclosures most often accessed and reduce those disclosures that are of little or no interest. This should improve understanding and communication while reducing costs to corporations and, ultimately, to the shareholders.

Improving Corporate Governance and the Effectiveness of Audit Committees

Recommendation 9: Effective implementation of the 1999 Blue Ribbon Panel Recommendations re audit committee financial experts.

In 1999, the *Blue Ribbon Panel on Audit Committee Effectiveness* called for all audit committee members to be financially literate and for each committee to have at least one financial expert.

FEI recommends that the NYSE and the NASDAQ set **higher standards** for audit committee "financial experts." These criteria should call for explicit experience requirements in the credentials of such experts. A financial expert should possess:

- An understanding of Generally Accepted Accounting Principles (GAAP) and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. We believe it is important for someone on the audit committee to have a working knowledge of those principles and standards.

- Experience in the preparation and/or the auditing of financial statements of a company of similar size, scope and complexity as the company on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in appropriate accounting estimates, accruals, reserve provisions, etc., and an appreciation of what is necessary to maintain a good internal control environment.

- Experience in the internal governance and procedure of audit committees, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee or an external auditor responsible for reporting on the execution and results of annual audits.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 10: Continuing professional education for audit committee members.

FEI recommends that all audit committee members attend continuing education in areas of financial reporting, risk management and/or accounting. Training can be "in-house" or via an outside provider. FEI, the National Association of Corporate Directors or an equivalent entity should establish the minimum content to be covered. Companies should disclose in the annual audit committee report whether members have undertaken such training. Non-audit committee directors are also urged to attend these sessions.

Recommendation 11: Periodic consideration of audit committee chair rotation.

FEI recommends that boards of directors periodically evaluate the need to rotate the individual holding the audit committee chair. Such evaluation may be done approximately every five years. FEI recognizes that outstanding audit committee chairs are valuable and difficult to replace. Yet there is also benefit in developing successors and additional financial experts on the audit committee. Therefore, rotation and successor development may further strengthen the overall governance mechanisms within the board.

Recommendation 12: Disclosure of corporate governance practices.

FEI recommends that all companies annually report their key corporate governance practices. Current best practice in many companies is to have a governance and nominating committee made up of independent directors.

Closing

FEI formed a task force of members to assemble this set of recommendations. The task force also had significant input from FEI's Committee on Corporate Reporting. These recommendations were then reviewed and approved by FEI's Executive Committee led by FEI Chairman David Young, CFO of Adaptec, Inc., and FEI Vice Chairman Ridge A. Braunschweig, CFO of Orion Corporation. FEI wishes to acknowledge and thank those involved in the preparation of this report. Also, special thanks to the contributions of Barry Brooks, partner, Paul, Hastings, Janofsky & Walker LLP.

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David H. Sidwell
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Chief Financial Officer - Investment Bank

APPENDIX A: Code of Ethics of Financial Executives International

FEI CODE OF ETHICS

FEI's mission includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected and preserved. This Code provides principles to which members are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public and other stakeholders. Violations of FEI's Code of Ethics may subject the member to censure, suspension or expulsion under procedural rules adopted by FEI's Board of Directors.

All members of FEI will:

- ✓ Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
- ✓ Provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.
- ✓ Comply with rules and regulations of federal, state, provincial and local governments, and other appropriate private and public regulatory agencies.
- ✓ Act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
- ✓ Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
- ✓ Share knowledge and maintain skills important and relevant to constituents' needs.
- ✓ Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.
- ✓ Achieve responsible use of and control over all assets and resources employed or entrusted.

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Attachment 2: January, 2004 Survey Results

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FEI Survey on Sarbanes-Oxley Section 404 Implementation
©January 2004

Executive Summary

In response to numerous inquiries about the implementation costs for Sarbanes-Oxley Section 404 compliance (internal controls), FEI conducted a survey of members from public companies, and received responses from 321 companies during the week of January 26. The size of the responding companies, measured by annual revenues, tended to be large, with 20% of the companies having more than $5 billion in annual revenues, and only 3% of the companies having less than $25 million in annual revenues:

Annual Sales Revenues	Percentage of Respondents
Less than $25 million	3.3%
$25 to $99 million	9.7%
$100 to $499 million	19.3%
$500 to $999 million	17.3%
$1 to $4.9 billion	30.0%
Over $5 billion	20.3%

Almost 38% of the responding companies were from the manufacturing sector, with tech, retail, financial services and transportation, among other industries, also represented.

Question 1a
How many internal people hours do you expect to need to comply with Section 404/Management Report on Internal Controls?
Companies expect to spend an average of 12,265 people hours internally to comply with Section 404/Management Report on Internal Controls. The number of hours is directly proportional to the size of the company. For example, companies with less than $25 million in revenues expect to spend an average of 1,150 hours, while companies with over $5 billion in revenues expect to spend an average of 35,000 hours.

Question 1b
How many external people hours do you expect to pay for to comply with Section 404/Management Report on Internal Controls?
In addition, companies also expect to pay for an average of 3,059 external people hours (excluding fees for auditor attestation) to comply with Section 404/Management Report on Internal Controls. These external hours exclude auditor's fees for attestation. Again, the number of hours is directly proportional to the size of the company. For example, companies with less than $25 million in revenues expect to pay for an average of 846

hours, while companies with over $5 billion in revenues expect to pay for an average of 6,197 hours.

Question 2

What is your estimated cost, in thousands, for external consulting, software, and other vendor charges needed to comply with Section 404 (excluding auditor's fees for attestation)?

In total, responding companies expect to pay an average of $732,100 for external consulting, software, and other vendor charges to comply with Section 404. These vendor charges are before annual auditor attestation fees, and are proportional to the size of the company. For example, companies with less than $25 million in revenues expect to pay an average of $170,000, while companies with over $5 billion in revenues expect to pay an average of $1,390,100.

Question 3a

What is the additional audit fee you expect to pay for the public auditor attestation report required by Section 404?

For the Section 404 annual auditor attestation, responding companies expect to pay an average of $590,100 in fees. Again, these fees are proportional to the size of the company by revenues. For example, companies with less than $25 million in revenues expect to pay an average of $52,200, while companies with over $5 billion in revenues expect to pay an average of $1,531,400.

Question 3b

What percentage is this fee of your total annual financial statement audit fee?

The incremental fee for the annual Section 404 auditor attestation represents an average increase of 38% over current audit fees. This percentage is similar regardless of the size of the company in annual revenues.

Question 4

What percentage of your processes are you documenting to comply with Section 404?

Much of the additional internal people hours will be used to document company internal control processes. Responding companies expect to document an average of 80% of their processes. This percentage is similar regardless of the size of the company in annual revenues. However, one in five companies will document 100% of their processes.

Question 5

What percentage of your documented processes do you expect your external auditor to actually test?

Responding companies expect that their external auditors will test an average of 57% of their processes. Smaller companies, those companies with less than $25 million in revenues, expected the least number of process tests by the auditors, expecting them to test an average of 42% of their processes. However, 27% of the companies expect their auditor to test 80 to 100% of their processes.

Question 6a
At what percentage of your company's physical locations will you document internal control processes?

Companies say that they will document internal control processes at an average of 79% of their physical locations. This percentage is inversely proportional to company size based on revenues. Companies with less than $25 million in revenues expect to document processes at an average of 87% of their locations, while companies with over $5 billion in revenues expect to document processes at an average of 78% of their locations.

Question 6c
What percentage of total revenues is covered by your documentation?

Companies say that this documentation covers an average of 92% of total revenues. This percentage is similar regardless of the size of the company in annual revenues.

Question 8
When do you expect to deploy a permanent tool solution for Section 404 compliance?

Only 25% of the responding companies have already deployed their permanent tool solution for Section 404 compliance. Another 52% of the companies plan to deploy their solution sometime during 2004, and 10% plan to deploy after 2004. However, almost 14% of the companies have no specific plans to implement a solution tool at this time.

Additional Questions

When do you expect to deploy a permanent tool solution for Section 404 compliance?

	Number	Percent	95% CI
Already completed	76	25.1 %	± 4.9 %
1st Quarter, 2004	47	15.5 %	± 4.1 %
2nd Quarter	52	17.2 %	± 4.3 %
3rd Quarter	35	11.6 %	± 3.7 %
4th Quarter	21	6.9 %	± 3.0 %
2005 or later	31	10.2 %	± 3.5 %
No plans at this time	41	13.5 %	± 3.9 %
Total	303	100.0 %	

Missing Cases = 18
Response Percent = 94.4 %

Responses by Industry

	Number	Percent	95% CI
Manufacturing	113	37.9 %	± 5.4 %
Tech [Software/Biotech]	36	12.1 %	± 3.7 %
Other	32	10.7 %	± 3.6 %
Retail/Wholesale	29	9.7 %	± 3.4 %
Banking/Finance/Insurance	24	8.1 %	± 3.2 %
Transportation/Energy	23	7.7 %	± 3.1 %
Communications/Media	17	5.7 %	± 2.8 %
Service/Consulting	15	5.0 %	± 2.7 %
Mining/Construction	9	3.0 %	± 2.3 %
Total	298	100.0 %	

Missing Cases = 23
Response Percent = 92.8 %

By Sales Revenue

	Number	Percent	95% CI
Less than $25 million	10	3.3 %	± 2.4 %
$25-99 million	29	9.7 %	+ 3.4 %
$100-499 million	58	19.3 %	± 4.5 %
$500-999 million	52	17.3 %	+ 4.3 %
$1-4.9 billion	90	30.0 %	± 5.1 %
Over $5 billion	61	20.3 %	+ 4.5 %
Total	300	100.0 %	

Missing Cases = 21
Response Percent = 93.5 %

By Number of Employees

	Number	Percent	95% CI
Fewer than 100	10	3.6 %	± 2.4 %
100-499	29	10.5 %	± 3.4 %
500-999	22	8.0 %	± 3.1 %
1000-2499	43	15.6 %	± 4.0 %
2500-4999	41	14.9 %	± 3.9 %
5000-9999	42	15.2 %	± 4.0 %
Over 10,000	89	32.2 %	± 5.1 %
Total	276	100.0 %	

Missing Cases = 45
Response Percent   86.0 %

By Headquarters

	Number	Percent	95% CI
Midwest	83	27.3 %	+ 5.0 %
Northeast	82	27.0 %	+ 5.0 %
Pacific	63	20.7 %	± 4.6 %
South Central	35	11.5 %	± 3.7 %
South Atlantic	24	7.9 %	± 3.2 %
Mountain	12	3.9 %	± 2.5 %
Outside U.S.	5	1.6 %	± 2.1 %
Total	304	100.0 %	

Missing Cases 17
Response Percent = 94.7 %

Attachment 3: July, 2004 Survey Results

FEI Special Survey on Sarbanes-Oxley Section 404 Implementation Executive Summary (July 2004)

In response to numerous requests, FEI has surveyed its public member companies twice in 2004 about their implementation costs for compliance with Sarbanes-Oxley (SOX) Section 404. The first survey was conducted during the week of January 26, 2004, to find out what costs companies expected to pay, both internally and externally. The second survey was conducted during the week of July 12, 2004, by which time companies had presumably received quotes from their external auditors for their first annual Section 404 audit.

Total estimated average “year one” costs for compliance with Section 404, per company, increased from almost $2 million in January to over $3 million in July, while “year one” costs as estimated by companies with over $5 billion in revenues almost doubled from $4.6 million to over $8 million.

In July, 224 companies responded to the survey. The size of these companies, measured by annual revenues, tended to be large, with almost 27% of the companies having more than $5 billion in annual revenues, and 16% of the companies having less than $100 million in annual revenues:

Annual Sales Revenues	Percentage (July)	Percentage (January)
Less than $100 million	16.1%	13.1%
$100 to $499 million	17.9%	19.3%
$500 to $999 million	12.1%	17.3%
$1 to $4.9 billion	27.4%	30.0%
Over $5 billion	26.5%	20.3%

Almost 32% of the companies responding in July were from the manufacturing sector, with tech, retail, financial services and transportation, among other industries, also represented.

Question 1a
How many internal people hours do you expect to need to comply with Section 404/Management Report on Internal Controls?

In January, companies expected to spend an average of 12,265 people hours internally to comply with Section 404/Management Report on Internal Controls. By July, when companies were well into their documentation process, this number had more than doubled to an average of 25,668 hours. Companies of all sizes increased their estimates of internal people hours that would be required for compliance.

As in January, the number of internal people hours reported in July was directly proportional to the size of the company. For example, companies with less than $100 million in annual revenues will spend an average of 2,143 hours, while companies with over $5 billion in revenues expect to spend an average of 73,312 hours.

Question 1b
What percent of these internal people hours represents work performed by internal audit staff?

The Public Company Accounting Oversight Board (PCAOB) permits external auditors to rely on the work of the company's internal auditors, to a certain extent. So companies were asked, in July, what percentage of the internal people hours represented work performed by internal audit staff. Overall, companies said that an average of 27.4% of their total internal people hours represented the work of internal audit staff.

The bottom line for the responding companies is that less than one-third of the additional time spent internally will represent work to be done by the internal audit staff, whose normal responsibilities include internal control documentation. The majority of the additional internal time dedicated to Section 404 compliance will be spent by non-internal audit staff.

Question 2
How many external people hours do you expect to pay for to comply with Section 404/Management Report on Internal Controls?

In January, companies expected to pay for an average of 3,059 external people hours (excluding hours paid for auditor attestation) to comply with Section 404/Management Report on Internal Controls. By July, when companies were probably working with outside consultants and other auditing firms to document their internal controls, this number had increased by almost two-thirds to 5,067.

As in January, the number of external people hours reported in July was directly proportional to the size of the company. For example, companies with less than $100 million in revenues expect to pay for an average of 837 external hours, while companies with over $5 billion in revenues expect to pay for an average of 10,834 hours.

Question 3
What is your estimated cost, in thousands, for external consulting, software, and other vendor charges needed to comply with Section 404 (excluding auditor's fees for attestation)?

In January, responding companies expected to pay an average of $732,100 for external consulting, software, and other vendor charges to comply with Section 404. These vendor charges were calculated excluding annual auditor attestation fees. By July, when companies had begun to hire consultants and purchase software, the total reported cost had increased by 41% to $1,037,100. This increase was driven by the increased estimates of companies with over $5 billion in revenues, which increased their expected vendor costs by over 70% from an average of $1,390,100 in January to an average of $2,389,900 in July.

Again, these vendor costs are proportional to the size of the company. For example, companies with less than $100 million in revenues will pay an average of $192,000, while companies with over $5 billion in revenues will pay an average of $2,389,900.

Question 4a
What is the additional audit fee you expect to pay for the public auditor attestation report required by Section 404?

In January, responding companies expected to pay an average of $590,100 in Section 404 annual auditor attestation fees. By July, when companies had most likely begun receiving actual quotes from their auditors, the average expected fees increased by almost 40% to $823,200.

Again, these expected audit fees are proportional to the size of the company by revenues. For example, companies with less than $100 million in revenues expect to pay an average of $259,500, while companies with over $5 billion in revenues expect to pay an average of over $2,000,000.

Question 4b
What percentage is this fee of your total annual financial statement audit fee?
In January, the incremental fee for the annual Section 404 auditor attestation was expected to represent an average increase of 38% over current audit fees. By July, the incremental fee for attestation was expected to represent an increase of over 53%.

As in January, this percentage is similar regardless of the size of the company in annual revenues.

Question 5
What percentage of total revenues is covered by your documentation?

In January, companies said that their Section 404 documentation would cover an average of 92% of total revenues. By July, there was very little change in this estimate.

Again, as in January, this percentage is similar regardless of the size of the company in annual revenues.

Total Year One Costs of Compliance

The total "year one" cost of compliance is defined as the sum of internal staff costs (each staff professional is assumed to work 2,000 hours per year and earn $100,000 per year in salary and benefits), costs of external consultants and vendors, and additional auditor attestation fees.

On average, the total year one cost of compliance per company was estimated to be almost $2 million in January 2004, but by July 2004 that cost had increased by more than 60% to over $3 million. This average increase was again driven by the estimates of companies with over $5 billion in revenues, which increased their expected year one costs by over 70% from an average of $4.6 million in January to an average of over $8 million in July.

PREPARED STATEMENT OF JAMES S. TURLEY

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ERNST & YOUNG LLP

SEPTEMBER 9, 2004

Mr. Chairman, Senator Sarbanes and Members of the Committee, I am Jim Turley, Chairman and CEO of Ernst & Young, one of the largest accounting organizations in the world. We have 103,000 people in more than 140 countries working in our global network of firms. Two years after the enactment of the landmark Sarbanes-Oxley Act (Act), it is appropriate to reflect on what we have been through, assess where we are today, and look ahead to new and remaining challenges. We should conduct this examination through the perspective of what is good for the economy and investors in the long-run.

But first, let me tell you that from what I see in the marketplace everyday, the Sarbanes-Oxley Act is working. In my opinion, the Act has brought about the most significant change in securities law and our profession since passage of the Securities Exchange Act of 1934. It has allowed investors to put a wall between the corporate and accounting scandals of the past several years and the future. It is encouraging and enabling our profession to move forward and make necessary changes and it is restoring investors' confidence in the financial markets.

The Accounting Profession's World Has Changed

The accounting profession has undergone historic change.

I became Chairman of Ernst & Young in the summer of 2001. Since that time, our relationships with the companies we audit and their audit committees have unalterably changed. The profession's regulatory structure is fundamentally different. After one hundred years, self-regulation of the accounting profession is over. The Public Company Accounting Oversight Board (PCAOB) now inspects, investigates, disciplines, and sets standards for auditors of public companies.

I believe that the formation of the PCAOB will prove over time to be one of the best things that ever happened to the accounting profession. A tough, but fair and independent regulator will make our profession and Ernst & Young better, while helping to restore the confidence of the investing public. The PCAOB provides a credible voice to judge how well the accounting profession is living up to our commitment to quality, and how effective we are in delivering on investors' expectations. PCAOB Chairman Bill McDonough and other Board members clearly are not afraid to challenge us. As a result, the entire profession is improving.

Ernst & Young Has Changed

At Ernst & Young we are committed to cooperating with our new regulator and to being more transparent so that the investing public feels more confident about what we do, and so that the regulators understand our challenges and our commitment to doing quality work. I know this is true for other firms within the accounting profession as well.

Just as important, and perhaps not as obvious, are the changes taking place inside the accounting firms. At Ernst & Young we have completed a top-to-bottom review of our business practices. In Fall 2002, I appointed one of our most senior client serving partners to the position of Vice Chair-Quality, reporting directly to me. Importantly, this post was established to be independent of our audit, tax, and transaction service lines and the charge was to leave no stone unturned. As a result, every policy, every practice, every performance system, and every training system has been reexamined and positive changes made. All our personnel have been challenged to do the right thing.

As Chairman, I have tried to make it very explicit to every one of our people around the world that our strategy is to have the best people providing absolutely the best quality to the marketplace. Setting the tone for our firm's culture and direction is one of the most important responsibilities I have. When I talk with our personnel about our strategic approach, it is really quite simple. I try to paint a mental picture of three pillars—people, quality, and growth. Having the best people delivering the best quality is the way to achieve the growth we need to reinvest in our firm and provide opportunities for our people. As we consider those three pillars, it only works from the left to the right. It does not work starting at the end and chasing growth for growth's sake, and then trying to find the people to do the work in a quality manner.

Quality is the key driver for everything we do. We are very mindful that maintaining this quality is key to the successful execution of the public-interest role we play in the capital markets.

Where We Are Today

Today, because of the Act and similar efforts around the globe, investors have good reason to be increasingly confident in capital markets and financial reporting. The Act has had a significant impact on audit committees, corporate management, and auditors, including the regulation of the profession.

Changed Behavior of Audit Committees

As you know, issuing a set of financial statements involves three key players and a system of checks and balances. Management works with the company's internal accountants year round to maintain the company's financial information and, in doing so, prepare the financial statements. The audit committee, pursuant to the Act, oversees the company's financial reporting process and hires the independent auditors. And, the independent auditors audit the company's financial statements to test management's assertions as to the accuracy and fair presentation of the financial statements before they are issued.

As part of this three-way relationship, auditors meet with management and the audit committee to discuss the financial statements. Before Sarbanes-Oxley, the conversations would regularly be a dialogue between management and the auditors, which the audit committee observed. Today, that triangle has been totally changed and turned on its head. Conversations are now between the auditor and the audit committee as they critically examine the judgments and estimates underlying management's decisions affecting various components of the financial statements. Management at times is not even in the room.

Audit committees, as surrogates for investors, are in charge today. They hire and fire auditors and evaluate the audit firms on an annual basis. Audit committees scrutinize the appropriateness of each service we deliver before we are retained to deliver it and before we deliver it. This is the audit committee preapproval process that Sarbanes-Oxley demanded.

Audit committees are taking the preapproval process very seriously. While some commentators would choose to further restrict the services that accounting firms can render to companies we audit, I think audit committees are appropriately restricting and preapproving services based on what is in investors' best interests. The proxy data demonstrate that companies are, in fact, implementing the law. We should give Sarbanes-Oxley time to work before contemplating any further change that might reduce the flexibility afforded audit committees to promote audit quality and investors' interests.

In executing their new oversight responsibilities, audit committees that used to meet three or four times a year for an hour or so are today meeting eight, or even ten times a year, sometimes for upwards of six to eight hours at a time. However, what gives me greatest confidence in the new enhanced audit committee is the *quality* of their focus and not just the quantity of their meetings.

Audit committees are increasingly and properly focused on what I call the five "C's." They are focused on understanding the *complexity* of the businesses they are serving and how that complexity translates into risk. Overly creative transactions are being exposed and more closely examined or eliminated. Sarbanes-Oxley's emphasis on the importance of internal *controls* is understood and embraced as a tool for helping to prevent and detect problems within companies. Coziness, not just between the auditor and management but also between the Board and CEO is not tolerated. And finally, the audit committees are focused on drilling into the *choices* that management is making. Day in and day out, CEO's and CFO's have to make choices related to accounting policies, estimates, judgments and everything else, and it is those *choices* that dictate whether the financial statements they prepare are conservative, appropriately so, or not.

It is an amazing change. In the past 18 months, I have attended many audit committee meetings and I wish that investors, and frankly anyone who is skeptical about the changes that are occurring, could see the positive changes taking place inside audit committees and the profession.

I know of many instances in the last 2 years where a company had to find a new auditor and the audit committee rejected management's recommendation and hired a different firm instead. That almost never happened before passage of the Sarbanes-Oxley Act. Audit committees are engaged in a very real way and are making decisions based on what is best for investors. We should give them and the Act time to work.

Changed Behavior of Management

Not to be overlooked in a discussion of the positive changes brought about by the Act is the strengthened accountability of corporate officers to investors.

The challenges posed to corporate management by the Act have been significant. While some have chafed at the new requirements and burdens of the law, the overwhelming majority of corporate executives are embracing it. Every day they are working to create value for investors, generate growth, and steer their companies forward within the boundaries set by the securities laws.

Nonetheless, it is clear that, in some cases, insufficient management oversight and inadequate financial controls were at the heart of the string of U.S. corporate failures that led to passage of the Act. Something needed to be done.

In this regard, I believe that the CEO and CFO certification requirement is one of the most important aspects of the Act in terms of driving management behavior. It requires CEO's and CFO's of public companies to sign their names to certify the accuracy of financial statements and the effectiveness of internal controls. This demand on the top has led to a process underneath that is realigning behavior. The certification requirement has helped drive change throughout all ranks of the corporate structure.

Let me give you an example. Not long ago, I was discussing Sarbanes-Oxley with the CFO of one of the world's largest companies, one that is based here in the United States. When asked about his perception of the Sarbanes-Oxley Act his response surprised me. "Jim," he told me, "in the old days I had to take out my hammer"-that is the word he used -"and beat down crazy ideas that my own people were bringing to me on a quarterly basis, ideas for recognizing revenues before we would really earned them . . . ideas for deferring expenses that should have been reported. But today, all of our people around the world recognize that we have to make money the old-fashioned way, by shipping product and billing and collecting for it."

What this CFO described is a real change in behavior that has resulted in an exponential increase in dialogue within company hierarchies. Today, corporate management is more interested in transparency and accuracy and less interested in overly creative ideas. Accountability is cascading through every business unit of every company. This change is a direct result of the Sarbanes-Oxley Act.

Changed Behavior of Auditors

As I stated earlier, at Ernst & Young, we are reexamining every policy, every practice, every performance system, and all of our training routines and challenging ourselves to do better. Our communications, the tone from the top, and even our business strategy make it clear that quality is our key objective.

I know that our partners and other executives at our firm are renewing their commitment to "the basics" of the audit function. We are digging deeper, looking at more evidence to support representations, and documenting our work more thoroughly. We have expanded the responsibilities of the independent review partner. We have added more rigor to our audit process, but by far the most significant changes are in the mindset and behavior of our professionals. They understand that performing audits of the highest quality is their most important day-to-day responsibility.

At Ernst & Young, we also have taken many other steps over the past 2 years to align our organization, policies, and processes to enhance the quality of our services. Let me provide you with just a few examples of what we have accomplished.

We have reinforced the tone at the top by refocusing our processes for evaluating and compensating our audit partners. We adopted a year in advance the new SEC rule prohibiting the evaluation and compensation of audit partners based on the sale of nonaudit services to their audit clients. To drive further improvements in audit quality, we are rewarding our best auditors, we are rewarding actions that enhance quality, and we are imposing sanctions where necessary.

We have significantly increased the number of technical resources who are consulted by our people and who make the firm's final decisions on accounting, auditing, and reporting matters. In addition, we have established new networks, such as a senior client service partner network to mentor and share best practices with our people on client-related matters.

We have redesigned and significantly increased the amount of training provided to our audit professionals. Since December 2002, our people have participated in 460,000 hours of training in the specific areas of Section 404 and internal controls and audit risk assessment. During the same period, our people participated in an additional 60,000 hours of training focused solely on fraud and lessons learned.

We have realigned and expanded the resources devoted to our quality controls over our independence from our audit clients and have implemented many new policies, procedures, and processes, including new ones regarding business relationships with audit clients. And we are taking measures to ensure we have best-in-class procedures to verify our independence from audit clients.

We established an ethics hotline and Ethics Oversight Board to provide an environment and culture where our people can speak up, raise any concerns they may have, and get action.

Our client acceptance and reacceptance processes have been reengineered with an increased focus on determining which companies we really want as audit clients and culling out those that we do not believe have adapted to the new environment and demands on a public company.

Clearly, much of the change in the behavior of auditors comes from their own individual sense of professionalism and the changes that are being made inside firms like ours. However, as I noted earlier, the significance of the creation of the PCAOB must not be overlooked and the PCAOB's impact in driving future auditor behavior should not be underestimated. New requirements in PCAOB standards and the close scrutiny of PCAOB inspections already demonstrate how its actions will drive auditor behavior with lasting and controlling effect across the profession.

As we look at where we are today, there is enormous and, I think, sustainable change in the behaviors of boards of directors, audit committees, corporate management, and firms like ours. From an insider's view, there is real reason for investors to regain faith in the integrity of financial information and the capital markets.

Remaining Challenges

Finally, I would like to focus on the road ahead. The integrity and reliability of financial reporting is fundamental to the capital markets. Even with Sarbanes-Oxley in place, there are some lingering issues that the accounting profession is focused on addressing.

Some of the remaining challenges relate to what is commonly known as an "expectation gap." Our profession has struggled for years with an expectation gap between the amount of fraud detection that the public has expected and the level of assurance that a properly conducted audit is designed to reasonably deliver. Additionally, there is a break between expectations and reality as it relates to the precision of financial reporting and the exactness that results from an audit. Both of these expectation gaps, one dealing with fraud and the other with precision or exactness, must be attacked from both ends, through education on one hand and more robust audits and financial reporting on the other.

Fraud Expectation Gap

The accounting profession has spent decades grappling with closing the expectation gap around fraud detection. From the Cohen Commission in the 1970's, to the Treadway Commission in the 1980's, and then the Professional Oversight Board's Panel on Audit Effectiveness in the 1990's, policymakers, academics, and the profession have examined the issue and sought to educate the public as to the inherent limitations of an audit that relies in many ways on management representations and sampling. But simply trying to explain what an audit does and does not do, on its own, has never been successful and is simply not enough. More is required. We must do better.

We are committed to working with the PCAOB to address auditing standards around fraud to do all we reasonably can in light of costs and benefits to investors. The Sarbanes-Oxley Act has already given management, auditors, and investors a new tool against fraud with the strengthened effectiveness of internal controls that will result from the Section 404 requirements. And as I mentioned earlier, we are spending many more resources training our professionals on fraud detection. In conjunction with the PCAOB, we have to be more focused on deterring and detecting fraud. Yet, the investing public will have to try to understand the reality that well-conceived criminal acts may go undetected even if an audit is performed fully consistent with standards.

Precision of Financial Information

The second expectation gap, related to the precision of financial reporting, was described as a "brittle illusion of exactitude" in a report by the American Assembly Project, a nonpartisan public policy think tank affiliated with Columbia University.

The February 2004 report, entitled "The Future of the Accounting Profession," noted the pervasive disconnect between financial statements that are, by necessity, based on educated estimates and judgments, and the expectation that financial reporting is a precise science in which a "right number" can be accurately derived. To manage expectations, the Assembly report urged auditors, and the investing public, to recognize that nearly every number on a balance sheet or income statement is the result of a series of estimates, assumptions, and accounting choices by managers that are reviewed and tested only to a degree by auditors.

It concluded, among other things, that the investing public must accustom itself to a new reality, one which it may find unpalatable: That the complex economy in

which companies do business today makes it difficult for even the most competent of accountants, internal or external, to ascribe a precise value to many corporate assets or transactions. Demanding that degree of precision, the report concluded, is simply unrealistic. However, the need for appropriate disclosure and broader acknowledgement of such imprecision should be examined.

Addressing the expectation gaps around fraud and precision is an important step in restoring the public trust in our integrity and objectivity. The creation of the PCAOB presents an historic opportunity for the accounting profession, the PCAOB, other policymakers, academics, and the public to work together to close the expectation gaps and make sure that the investing public is best served by our profession.

Internal Controls Reporting

While I embrace the emphasis on internal controls set forth in Section 404 as a valuable tool for helping to prevent and detect problems within companies, I am concerned that most investors, the general public, analysts, and the media know little about the 404 reporting process and what potential findings may mean. So far, much of what they have heard is concern about cost of compliance from some in the issuer community.

With the reports required under Section 404 of the Sarbanes-Oxley Act first due in early 2005, it is time to move past arguments against 404 requirements and get into educating and informing around the results. Without such an effort, there is a significant risk that the public will misinterpret, and overreact to, an assessment that a public company's internal controls are deficient and warrant improvement. Without sufficient understanding, some may wrongly equate an internal control weakness with financial statement inaccuracy.

Let me cite two aspects that will need to be addressed through communication and education. First, it appears there is the potential for many more material weaknesses to be reported and adverse opinions issued than perhaps anyone imagined. This is due to many factors other than the Act itself. For most companies, this will be the first time that internal controls have been scrutinized to the degree that 404 and the resulting SEC rules and PCAOB standards require. Scrutiny will come from both management and the independent auditor.

Although some leading companies got started before the rules and standards were even finalized, many companies have been slow to start the assessment process and may not have time before year-end to remedy any deficiencies noted during the process.

In addition, the PCAOB auditing standard is rigorous and sets a high bar for companies to achieve a passing grade. How will the public react to a potential proliferation of material weaknesses and adverse opinions? How will the capital markets react? Is it enough to say the numbers of such findings will decrease over time as weaknesses are identified and subsequently remedied? There should be an informed reaction and response when internal control problems are surfaced, but not an uninformed overreaction that undermines investor confidence in reported financial information. This is a concern that can be managed but warrants a focused and shared effort.

Second, there is the potential for a new expectation gap, a gap between the comfort that some might derive from a company and its independent auditors reporting a passing grade on internal controls and their later dissatisfaction when the company does not meet its financial goals, makes significant changes to its critical accounting estimates, or based on subsequently discovered information is required to restate previously issued financial information. The profession will conduct thorough audits of internal controls over financial reporting, but as set forth in the standards the scope of these audits will be based on the concept of providing reasonable, not absolute, assurance.

Let me be clear. The benefits to investors from the implementation of Section 404 are significant in terms of improvements in the reliability of periodic financial reports, including quarterly reports and not just annual reports subject to a financial statement audit. But along the journey of achieving these improvements in financial reporting, we cannot allow each incidence of subsequently discovered information to shake investor confidence in financial reporting through an uninformed overreaction.

We, the profession, policymakers, issuers, directors and investor leaders, need to collectively engage in a public dialogue to educate others regarding the new internal control reporting process and how to interpret potential findings and responses. In conjunction with the other major firms, we are beginning that effort and look forward to working with others in this effort.

Continued Implementation of the Act

It also is clear some people outside of our profession are concerned with the rigorous requirements of the Act, the strength and scope of the processes imposed, and the increased work auditors are required to perform. Some of this relates to the new internal control reporting requirements. Many of you have told me about the complaints you have heard. I have heard many of the same concerns. It is important to find the point where good corporate governance and economic performance and protection complement rather than conflict with each other. I think that is important to keep in mind as the Act is being implemented.

However, as implementation continues on many fronts, I would encourage refraining from change to the direction set forth in the Act itself. Instead, give boards, audit committees, management, auditors, and others time to fully implement existing requirements.

Let me directly address this issue of implementation as it relates to our work as auditors. Yes, we are being tough. The law requires it, the PCAOB is inspecting our work every step of the way, and investors expect nothing less from us. And as we adapt to address heightened auditing standards, fraud detection expectations, internal control reporting demands, and other new requirements, the amount of work we do will surely increase and, as a result, costs will surely rise. Such new requirements are part of our professional obligations for which we are increasingly held accountable if we fail to uphold them. In this process, Congressional leaders and regulators have stood behind the law's requirements and the accounting profession's efforts to carry them out faithfully, and for that we are appreciative.

Sustainability of the Accounting Profession

Finally, I would like to address two issues on the horizon that will affect the long-term sustainability of the private sector audit function.

Unless our profession can continue to attract and retain the best people, and deal with the economic risks our people face as partners, the public accounting firms as we know them today could be in jeopardy.

While we have experienced a recent surge in entrants to the accounting profession, the long-term trends have been headed down. We face real challenges in sustaining the pipeline of quality people into the accounting profession. We need to attract highly competent people to the profession who are not only good with numbers, but who are also able to communicate with audit committees and management. They need to understand our values and that what they do is incredibly important to the free-market system.

In addition to new entrants to the accounting profession, it is just as important that we retain the extraordinary talent that we already have. The Sarbanes-Oxley Act's requirements and pressures put a great strain on our ability to retain sufficient personnel of the caliber we need at various experience levels to meet the demands we face. The demands of not only auditing financial statements but now also auditing internal controls have strained resources across the profession. These resource constraints cannot be allowed to put the quality of any of our work in jeopardy. In addition to the impact of tougher client acceptance and retention practices, all the larger firms are resigning from significant amounts of work in order to make available resources to do the necessary audit work in a quality manner. Even with that, the demands on our people are intense. The second risk to our sustainability is the ever-increasing cost we bear to simply stay in business. Practice protection costs weigh heavily on our firm and the profession. Insurance premiums have soared, both absolutely and relatively as a percentage of our revenues. For our U.S. firm, practice protection has become one of our largest costs, second only to our personnel costs.

In our very litigious environment where class-action lawsuits are filed at the drop of a hat and the cost to defend against them is so high, public accounting firms face significant financial risk. While we try to minimize these costs by performing in a manner that strictly adheres to professional standards and regulatory requirements, unfortunately good auditing is all too often not a sufficient defense.

Conclusion

All of us—accounting firms, Congress, the SEC, the PCAOB, and other capital market participants—must do a better job educating the public on the reforms that have been put in place.

Recent research among investors commissioned by the four major accounting firms shows that the investors who are most aware of the reforms that have been put in place by the Sarbanes-Oxley Act have far greater confidence that what needed to be done is being done.

This research points to the need for broader education of the investing public on their new protections under the law. We should all be more proactive in highlighting the whistleblower provisions, the CEO certifications, the nonaudit service restrictions, and the fact that you created a new regulator for the profession. We should be talking more about the internal control requirements to curb fraud and how Congress made it a crime to lie to the auditor and people can go to jail because of it.

Investors need to come to appreciate how audit committees with strengthened oversight are clearly acting as surrogates for investors' interests. There is a lot in the law and I touched on a few things. This is something all of us should give voice to every chance we get until investors better understand what has been done.

Finally, I would like to address the recently released PCAOB inspection reports. The inspections underscore the PCAOB's commitment, on behalf of the investing public, to review our auditing policies and processes; and our cooperative participation underscores our commitment to be transparent with our regulator.

While nobody likes to be inspected by their regulator, I truly believe that Ernst & Young and the entire profession will be better for it. Without question, in this process we will come to understand that there are things that some of the other firms might be doing better than us and the other firms will learn of things that we at Ernst & Young do better than them. I embrace the process because I think the whole profession, and investors' confidence in us, will improve markedly.

In closing, I would like to thank this Committee, the Congress, the President, the Securities and Exchange Commission, and the Public Company Accounting Oversight Board for your work in creating and furthering the implementation of the Sarbanes-Oxley Act of 2002.

PREPARED STATEMENT OF GREG BENTLEY

CEO, BENTLEY SYSTEMS, INC.

SEPTEMBER 9, 2004

Good afternoon, Mr. Chairman and Members of the Committee. My name is Greg Bentley and I serve as the Chairman, President, and CEO of Bentley Systems, Inc., which is headquartered in Exton, Pennsylvania, near Philadelphia. I note the presence of Senator Santorum on this Committee and offer our sincere thanks for his service to the citizens of the Commonwealth and our Nation.

As a member of the American Business Conference, founded by Arthur Levitt almost 25 years ago, I am honored to represent a growing majority of our economy—privately held companies, and businesses smaller that you hear from most—regarding the Sarbanes-Oxley Act. Significantly, Bentley Systems remains a private company today, despite having filed our preliminary registration statement for an initial public offering in April 2002. We stayed the course in registration despite the seven-figure cost of hiring a second firm to reaudit our financials, replacing Arthur Andersen, our longtime auditors. In retrospect, the delay turned out to be fortuitous, as it coincided with the promulgation of Sarbanes-Oxley, whereupon we withdrew our offering.

I believe our experiences in this regard are relevant to your assessment of policy formulations to stimulate continued entrepreneurship, growth in the private sector, and a robust national economy. To us, this is so critical that in return, I will divulge what I have referred to as the "secret sauce" behind our business success to date. Last week, I heard a compelling articulation of an "ownership society," within which I want to advocate the importance and preservation of our company's "ownership culture."

Our 1,600 colleagues at Bentley Systems last weekend observed the company's 20th birthday. During this lifetime we have grown from (literally) a "band of brothers" to about $300 million of annual revenues, profitably and primarily self-financed. We rank among the larger firms within the global applications software industry, and among the very largest of those that have remained private companies. Our software supports the architecture, engineering, construction, and operations of the world's physical infrastructure. Our products are used, by way of example, to design the majority of roadways, manufacturing plants, and water/utility networks in most major countries in the world.

In growing tenfold over the past decade, we have created over 700 jobs in the United States, with average annual compensation here of over $90,000; and our exports contribute over $150 million per year to the U.S. trade balance.

While I and my four brothers (all of them engineers) who founded and control the company work hard and plan to continue doing so, we have always recognized that

our growth and success is entirely to the credit of our colleagues, who comprise all the key assets for producing and vending our software. By 2002, the number of colleagues to whom we had granted stock options was approaching the limit of 500 (made famous recently by Google), above which, under current law, formal disclosures, and consequently now Sarbanes-Oxley adherence, are required. The motivation for our IPO filing was thus less to achieve *public* ownership per se, but rather to make available deserved liquidity for these option holders, to appropriately reward their ongoing efforts and results.

At this same time, it happens that I chaired the audit committee of a large public (S&P 500) IT services firm. As a consequence, my personal experience with the various emerging costs and burdens of Sarbanes-Oxley compliance led us to conclude that such costs and distractions would not be prudent for Bentley Systems at the time.

In summary—because I realize you have other witnesses to present the perspective of existing public companies—those costs and burdens are substantial, and are still increasing, and their ultimate extent is still uncertain, depending on how new audit standards end up getting put into practice. Most of us are prepared to accept that in the aggregate these costs are probably justifiable, to preserve confidence for public investors.

And frankly, many aspects of Sarbanes-Oxley represent sufficiently worthwhile notions (such as executive attestations, whistle-blower hotlines, and some degree of explicit and audited internal controls documentation) that, though we expect to remain private for the foreseeable future, we have begun a deliberate (hence, relatively frugal) implementation process at Bentley Systems.

But beyond the new compliance costs, what settled Bentley's IPO withdrawal was the mismatch between new corporate governance requirements, and our own ownership culture. In particular, the Act obliged exchanges to promptly propose new listing standards, the drafts of which dictated, for the first time, a majority of independent directors, which we have never contemplated.

It remains especially implausible to me, candidly, that our founders would relinquish control to such potential new independent directors as would be willing to expose themselves to the "perfect storm" of liability risks unleashed by Sarbanes-Oxley, especially for new public companies.

To start with, I am afraid that an appropriately long-term management horizon to best serve long-term shareholders is inherently incompatible with infallible short-term earnings visibility. But even if consistent and predictable fundamental performance could be a given, I believe that current U.S. GAAP accounting standards make financial restatements more likely than not. This is because these Byzantine rules and picayune bureaucratic interpretations change frequently—and often with retroactive effect—superseding what should be constant and overriding principles for measuring financial performance with consistency.

From my lay standpoint, to the extent that convergence with international accounting standards would reinstate principles-based accounting rather than "rules-based" accounting, every CEO should favor such a change.

In the meantime, occasional downside earnings surprises are inevitable, with impact on stock prices. I believe that rational equity investors can and must (as they once did) take this in stride. Unfortunately, Sarbanes-Oxley has increased the very real apprehension that hair-trigger plaintiffs' lawyers will misuse the Act's standards to exploit these "gotcha's" as windfall opportunities, sapping (and, deterring) competent and well-meaning management and boards, with their deadweight of expensive distraction.

From a public policy standpoint, in fact, I believe that relatively simple litigation reform could more immediately and effectively redress the excessive risk aversion that Sarbanes-Oxley has engendered, than complicated rework of its complexities.

Otherwise, growing and prospering companies like Bentley Systems will assuredly remain private indefinitely. Not only will IPO's (other than perhaps spin-outs) be less prevalent, but also will acquisitions of private companies by public companies, who would effectively incur unaddressed Sarbanes-Oxley liabilities.

Are there national interests that may be at risk when a larger segment of our economy consists of larger private companies? One could be concerned that investors in public equities will have fewer choices among smaller growth companies where more investment capital, on the margin, could provide higher overall returns. On the other hand, there is presently an abundance of equity funds seeking private-company investments. Presumably such investors prefer the long-term orientation of private managements, to the enforced relative fixation of public companies on short-term earnings.

It is also clear to me that this providential abundance of long-term equity capital has been fostered by the recent structural tax reforms. Rolling these back to any

degree will reduce growth funding for our privately-led economy, while making them permanent will even more substantially increase the ability of firms like Bentley Systems to invest in faster growth of our exports and employment.

But financial capital, while essential, is far from sufficient for the United States to maintain and extend its world leadership in technology—such as the software which is key to growth in *all* of our industries, including those we serve at Bentley. In fact, financing would be useless without the key ingredient in our Bentley recipe—the ownership culture by which we attract, incent, and reward the colleagues whose intellectual property creation we are all dependent upon.

Post-Sarbanes-Oxley, our recipe's potency has been somewhat watered down, in a respect which I am afraid is representative of American companies at large. But the good news is that I also think there can be some simple public-policy changes, within the purview of your Committee, which could in fact serve even to improve upon the original recipe.

My first modest proposal would be to exclude equity grants to employees from the applicable count of "securities holders," so that larger private companies could extend their ownership culture to more than 500 colleagues without becoming subject to public-company regulatory burdens, since such grants are not the result of any securities purchase decisions.

I would also suggest a policy direction to update the *form* of ownership culture, which gets beyond the tedious controversy over option expensing. As a major shareholder myself, I am well aware of the costs of option grants, no matter where they are measured in financial statements.

But, of course, I am equally aware of their benefits, in our American success recipe. I support the pending legislation which would delay and circumscribe option expensing, but only because otherwise most companies are significantly reducing the breadth and scope of their option programs, without substitute ingredients to sustain their ownership cultures.

In fact, of greater concern to me, than their expensing, is that the negative attention to stock options has unfortunately associated with them the stigma of greed and corruption. On the other hand, this could open the door to fresh thinking.

Granting outright (or correspondingly restricted) shares instead of options would even more completely align employee incentives (to the downside as well as upside) with that of the stockholders at large. While under option expensing there would not be a relative accounting bias against this, unfortunately the employee would be subject to income tax upon vesting, without a source of liquidity other than prematurely selling the shares (if there is a public market), now that Sarbanes-Oxley precludes loans from the employer.

An evident solution would be to grant the stock into the employee's qualified retirement account, where its value could presumably accumulate indefinitely, tax-advantaged. The company could then even elect to pay a dividend on such shares, likewise tax-deferred. That would further leverage the secret sauce of ownership culture to focus companies on long-term cashflow generation, while at the same time focusing employees on long-term, stable career development, and retirement funds. It happens that company contributions, in stock, to our U.S. colleagues' profit-sharing accounts are already made annually at Bentley Systems. These contributions are over and above the company's cash 401(k) matches of colleagues' own cash contributions, so that this incentive is always incremental to baseline retirement financing, rather than a substitute. Also, many other companies take advantage of ESOP plans, authorized by Congress in acknowledgement that our national economic interests are served by encouraging broad employee ownership.

The problem with either means, as a candidate to replace broad employee stock options programs post-Sarbanes-Oxley, is that all such ERISA-permitted equity contributions must in effect be "nondiscriminatory"—that is, in essentially the same proportions of cash compensation to all employees. However, in the United States (and at Bentley Systems) we have always recognized that our colleagues' efforts and results are NOT correspondingly distributed equally. The ownership culture cannot generate its intended incentive leverage, when it is made into an entitlement.

So, I would ask that you consider creating an exception under ERISA for discretionary outright grants of stock to employees, for the purposes traditionally served by option grants. While many of the Enron abuses have been appropriately curtailed through Sarbanes-Oxley and related policy developments, our company, colleagues, and country can least afford to curtail the potent economic force of long-term equity incentives. This ownership culture secret sauce should be restored and reinforced as a key ingredient in our corporate and national economic strategies.

Thank you very much for this opportunity, and I look forward to questions.

PREPARES STATEMENT OF LEONARD MOODISPAW

PRESIDENT AND CEO, ESSEX CORPORATION

SEPTEMBER 9, 2004

I am the CEO of Essex Corporation, a publicly traded corporation located in Columbia, MD as well as a number of locations throughout the United States. We provide solutions to difficult communications and signal processing problems using our unique optical and signal processing expertise. Essex has grown from 45 employees and $4.5 million in revenue 2 years ago to 240 employees and estimated revenues of over $60 million in 2004. Most of that revenue comes from customers in the Department of Defense and Intelligence communities.

We are listed on Nasdaq as KEYW and have a market cap of approximately $140 million. Because Essex is a small cap company, we are not required to comply with many of the provisions of Sarbanes-Oxley (SOX) until 2005. Yet, we are mindful of the provisions and are preparing for full implementation.

In a recent commentary in *The Wall Street Journal*, the President and CEO of Nasdaq, Bob Greifeld, discussed the positive benefits of Sarbanes-Oxley. I support his views because I believe the implementing regulations are forcing companies to assess themselves and expunge embedded inefficiency that is detrimental to their bottom line and company culture.

Because Essex is primarily a Government contractor, we are subject to audits from various Government agencies. That scrutiny is in many ways as rigorous as those of SOX requirements and the results of noncompliance are as severe.

For example, the Defense Contract Audit Agency evaluates our systems and controls as part of their periodic audits. They evaluate our timekeeping systems, billing processes, and bidding estimation systems. They annually audit our actual costs against our expected costs and ensure that those costs are recorded in accordance with the cost accounting standards and/or generally accepted accounting standards. In addition, the Defense Logistics Agency reviews purchasing and inventory control procedures. Inadequate systems and controls can lead to denial of contracts and disbarment from performing work for the U.S. Government. If fraud or abuse is suspected, the Defense Criminal Investigative Service will investigate and criminal sanctions may be imposed if violations are proven.

Thus, I expect Essex and other companies who work in the Government arena are better prepared for SOX, mitigating new costs associated with compliance.

Clearly there are costs associated with complying with SOX and they will vary with such factors, among others, as the size of the company, centralization of functions, and geographic dispersion of subordinate units. However, there is a return on the investment and the costs should peak during preparation for compliance.

The Y2K (year 2000) experience may also be relevant in evaluating the cost benefit of SOX. Companies spent significant amounts to analyze the status of computers and related processes and procedures. As a result, many nagging documentation issues, needing correction for systems to operate more efficiently regardless of the date issue, were identified and corrected.

In a recent study of corporate data integrity, the Seattle-based Data Warehousing Institute found that nearly half the companies surveyed had suffered "losses, problems, or costs" due to poor data. The estimated cost of these mistakes was more than $600 billion.

I believe that the net effect of the effort to assure compliance with SOX will help focus companies on the elimination of erroneous data embedded in corporate systems by strengthening internal controls to ensure that such data are accurate and that laws are followed in carrying out operations.

As to return on investment; there are positive benefits to be gained, in addition to the well known goal of restoring investor confidence in public companies after the notorious Enron, WorldCom, and other debacles.

- Strengthening the role of audit committees and involving it is members more in risk assessment can only help management.
- Emphasis on the independence of directors not only adds to "checks and balances," but it also brings new talent to augment the leadership of companies.
- The value of target companies which are SOX compliant will be greater when considered for merger or acquisition.
- Financial institutions will be more likely to lend money to and invest in companies which are SOX compliant.
- Insurance coverage for Errors and Omissions policies for officers and directors should be less costly for SOX compliant companies.

- Candidates for boards of director posts should insist on SOX compliance before they serve on boards; thus, such companies are more likely to attract knowledgeable members.
- Executives are likely to demand SOX compliance as a condition of their employment.

However, these benefits pale by comparison to the expected increase in efficiency and effectiveness from scrutinizing financial and information technology processes. Recently, Essex acquired two companies. In the process of due diligence and integrating operations, we learned a lot about Essex as well as the two acquired companies as we shined the light of SOX on them. What are the "right checks and balances?" Who has the authority to make decisions at what level of expenditure? Who reports to whom in the organization? Are data protected? Do employees understand their ethical obligations? What training is necessary to obtain a compliance structure throughout the company?

These are just a few of the questions which need to be asked—without being imposed by regulations.

SOX may be relatively more costly for smaller companies who have such few people involved in some functions that it is difficult to separate them for internal control purposes. However, the benefits of having strong internal controls outweighs the costs.

There is a fear that companies will "go private" rather than subject themselves to SOX. I think this is unlikely because the SEC will properly question the motives of management and investors will wonder what the company wants to hide. Also, the cost of such an action can outweigh the cost of SOX compliance.

Another concern is that foreign companies will be reluctant to do business in the United States; I am working with a public company from England which is establishing a presence in the United States without fear of compliance.

SOX cannot be fully examined without commenting on the penalties for failure to comply. When articles on the subject routinely assert that CEO's "can mitigate their jail time" by certain steps, it gets one's attention! Also, some fear that audit firms *must* be tough on clients to demonstrate their independence. The negative impact on the price of a stock after such a finding may be significant; hopefully short-term as the company achieves compliance.

A few years from now, after the costs of compliance have peaked and the benefits are recognized, we will look back at this period as we do the Y2K era; the anticipation was worse than the event.

RESPONSE TO A WRITTEN QUESTION OF SENATOR SHELBY FROM ANDREW SHENG

Q.1. Mr. Sheng, my staff recently met with banking and securities officials with the People's Republic of China. During those discussions it became evident that there are differences in the way accounting standards are viewed by the People's Republic of China and Hong Kong. As an emerging economy, the People's Republic of China believes that it needs to take a different approach to adopting international standards. Could you please explain to me how each approach the establishment of accounting standards?

A.1. *Hong Kong's approach toward the adoption of international accounting standards.*

Hong Kong Institute of Certified Public Accountants (HKlCPA) is the standard-setter for Hong Kong accounting standards. Its power to set accounting standards comes from the Professional Accountants Ordinance (Chapter 50) of Hong Kong.

HKlCPA has adopted a policy of convergence with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. Because of the structure of the legislation in Hong Kong, the HKICPA issues its own standards rather than adopting IFRS directly. Under the convergence policy of HKlCPA, Hong Kong reporting standards will be word for word identical to the IFRS except for minor additional disclosure requirements.

International Accounting Standards Board has issued a package of IFRS's for the adoption by EU countries for accounting periods starting on 1 January 2005. Hong Kong standards, identical to these IFRS's, will also be effective for accounting periods starting from 1 January 2005. Hong Kong standards effective from 1 January 2005 include standards on financial instruments identical to IAS 39.

China's approach toward the adoption of international accounting standards.

The following answer was obtained from the China Securities Regulatory Commission (CSRC).

The Chinese Government, especially the Ministry of Finance (MOF) and the China Securities Regulatory Commission (CSRC), has been taking continuous and considerable efforts to facilitate the internationalization of the mainland accounting standards. MOF has issued 17 accounting standards for business enterprises, most of which are based on the IAS. The CSRC has also issued series of financial information disclosure standards specifically for the listed companies, and most of these requirements have absorbed the international practices from other developed capital market. Therefore, the mainland accounting standards have been substantially improved to meet the international accounting standards.

At the specific requirements level, there are a few differences between these two accounting standards. Currently most of these differences reflect China unique features as a transitional economy. Along with further reform and opening up, we will take substantial actions to facilitate the internationalization of the mainland accounting standards, as what we have been doing before. The difference should be further minimized in the near future.